KT&G Corporation

"Trust in all we do"

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

Company Profile

KT&G was founded in 1899 as an agency of the Imperial Household for tobacco and ginseng. During the twentieth century, the company became a household name in Korea as the nation's sole tobacco and ginseng manufacturer and distributor.

The year 2002 marked the beginning of a new era for KT&G as it made the successful transition from state-owned monopoly to free-market competitor. Through modernization of its facilities, rationalization of its workforce, and restructuring of its management, the company increased efficiency to meet the challenge of competing with overseas companies in the liberalized domestic market.

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

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

Head copy:

Korea Tomorrow and Global

Body copy:

The color blue symbolizes our dynamic corporate vision.

The corporate symbol expresses a gentler corporate image.

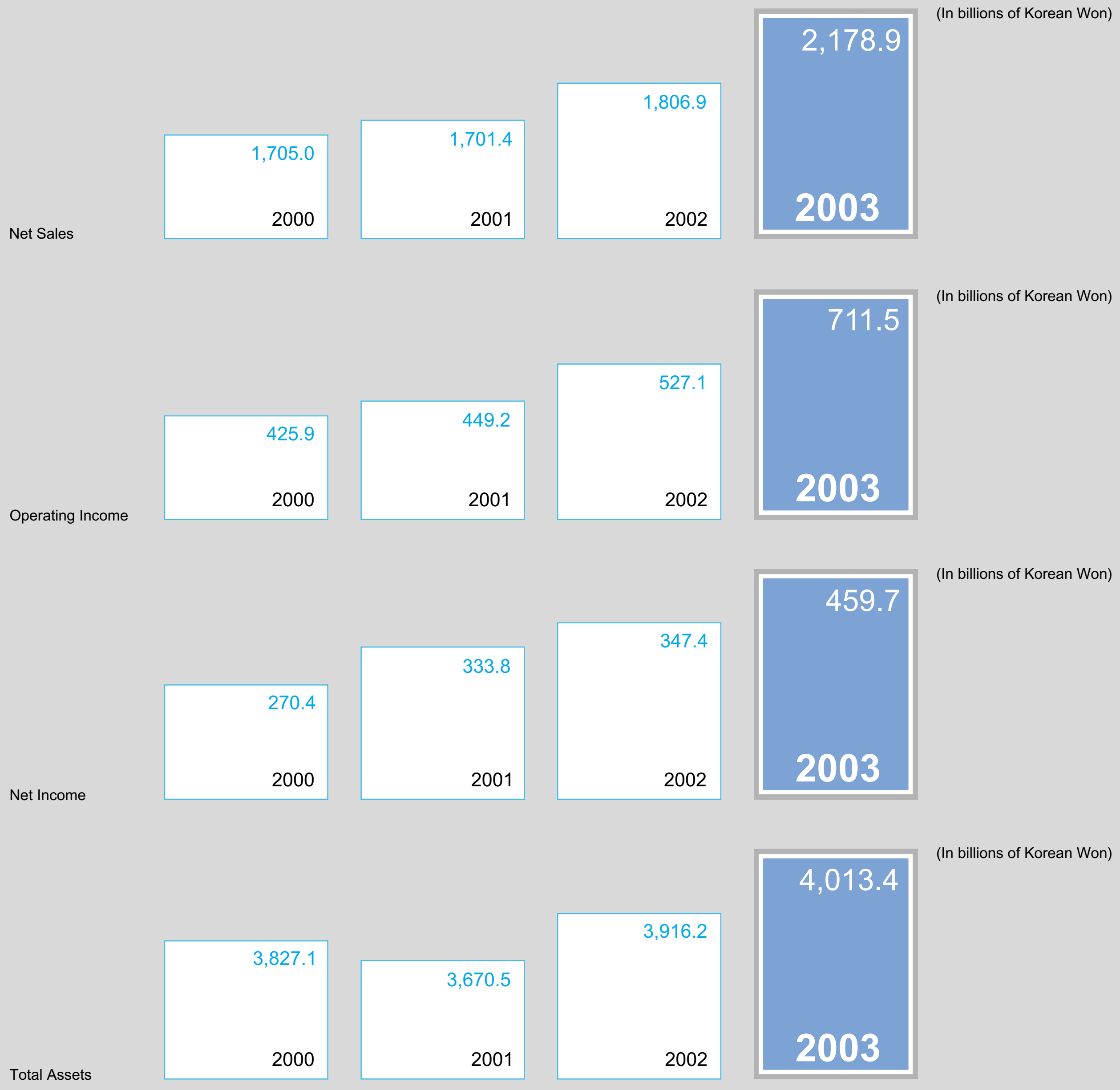
We will be
the most responsible company.

We will be
the most conscientious company.

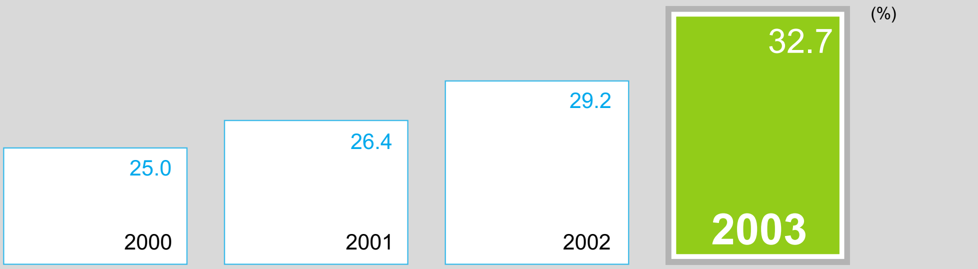
We will always stand by your side.

We will be your KT&G

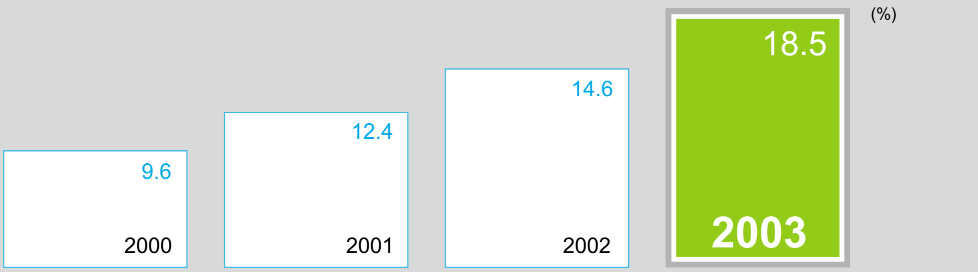
Financial Data



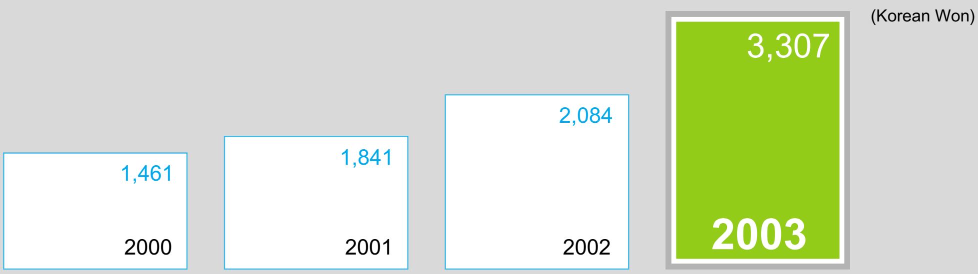
Operating Margin



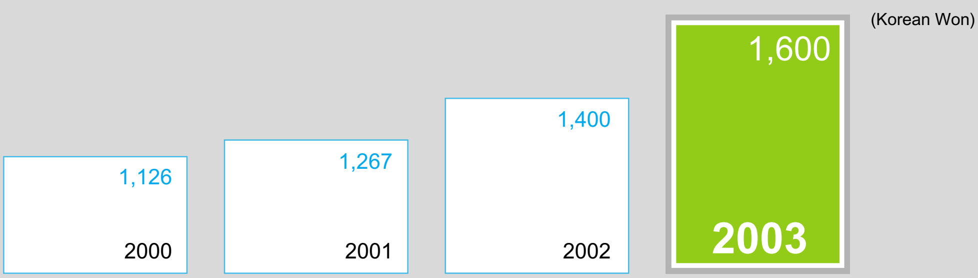
Return on Equity



Diluted Earnings per Share



Average Dividend per Share



To Our Shareholders

Dear shareholders,

I am pleased to report that in the first year of its privatization KT&G recorded the best performance of its long and distinguished history. In fiscal 2003, net sales rose to W2.2 trillion and operating profit soared to more than W700 billion. As a result, net profit increased by 32.3% compared to the previous year to total KRW460 billion in 2003.

In the domestic market, the successful launch of three new products, Raison, Seasons, and THE ONE, along with the

> “In our first year of privatization,
> we achieved a record net profit of ₩460 billion.”

The successful launch of our new brands Raison, Seasons, and THE ONE, along with the continued growth of Esse, reinforced our strong position in the premium and low tar cigarette markets.

continued growth of Esse, reinforced our strong position in the premium and low tar cigarette markets. The brands proved a major income source for the company and paved the way for a resurgence against our competitors in the domestic market. Our overseas business was another remarkable success. After just six years operating in overseas markets, in 2003 we achieved exports of 31 billion sticks.

In addition to record sales, ongoing plant rationalization and modernization contributed to profitability. In 2003, we completed the construction of a new factory at Yeongju, which raised total production capacity and enabled us to respond rapidly to changes in market demand. We also made progress towards eliminating the problem of oversupply and excess stocks of leaf tobacco, the effective management of which is a critical to maintaining global competitiveness.

In our first year as a privatized company, we continued to emphasize transparent corporate governance. In July, we became the first Korean corporation to publish a Corporate Governance Charter, which provides guidelines for maintaining the independence of the board of directors and the ethical management of the company. Our efforts were widely recognized and for the second consecutive year Credit Lyonnais Securities Asia named us among the top ten Asian companies for corporate governance quality.

Despite our strong performance over the past year, along with the rest of the tobacco industry we face serious challenges to long-term profitability. Among them, the adoption in 2003 by member nations of the World Health Organization of the Framework Convention on Tobacco Control had perhaps the farthest-reaching implications. In addition to its influence in developed countries, the effect of the Convention in strengthening tobacco regulations in developing nations has ramifications for export sales. At home, meanwhile, the likely ratification of proposed amendments to tobacco laws is expected to reduce demand and increase competition for market share in the short term. Moreover, the Korean government is committed to raising incrementally the taxes levied on tobacco sales.

To Our Shareholders

“The launch of new premium brands in 2003 saw us improve sales volume and profitability.”

In response to these challenges, we intend to reinforce our competitiveness in 2004 through the implementation of several strategies. We will continue to strive for greater satisfaction for our customers, value creation for our shareholders, and additional opportunity for our employees. To achieve these, we will focus on the following:

First, we will safeguard our dominant position in the domestic market. The domestic market remains essential to profitable revenue generation. However, continual price increases and stricter regulations are inhibiting growth in sales volume. To overcome limitations in volume growth potential, we will continue to concentrate on premium brands and seek to maximize profit. To accomplish that goal, we will focus on developing our advertising and upgrading the quality of our marketing. We will also continue to raise efficiency with our program of rationalization at manufacturing facilities and improvements in our domestic leaf tobacco processing.

Second, we will focus on expanding overseas markets and improving profitability by upgrading our overseas operations as follows:

1) We will employ market specialists and brand development in regional markets.
2) We will manage overseas agents effectively and centralize overseas advertising and sales promotions at headquarters Korea.
3) We will explore direct investment opportunities in major export regions.

Third, we intend to develop our ginseng business by expanding its range of products and focusing on high value-added functional foods and beverages. The ginseng business will provide us with both a source of stable revenue and a foundation for the development of a world-class health food company. Of course, we will review our strategy carefully to minimize risk and maximize potential profitability of the business.

Lastly, we will continue to restructure and innovate our organization. Attracting and retaining talented and committed human resources is crucial to our continued achievement. Measures such as the introduction of an incentive system and an employee stock ownership plan will undoubtedly contribute to maintaining improvement in our overall performance.

I would like to extend my sincere thanks to all our shareholders, whose encouragement has been invaluable during our first year as a private company. We are committed to rewarding your support with another outstanding performance in 2004 and beyond.

Thank you.

Chairman & CEO
Young-kyoon Kwak

We continued to emphasize transparent corporate governance in 2003 with the publication of a Corporate Governance Charter that ensures the independence of the board of directors and the ethical management of the company.

Highlights Of 2003

Privatization and rebranded corporate identity

Following its successful privatization at the end of 2002, KT&G began the new year with the launch of a new corporate identity. The company's new look was unveiled at a ceremony held on February 19 at which senior management reiterated KT&G's commitment to ethical codes of conduct and transparent corporate governance in creating shareholder value.

Corporate governance charter

Demonstrating its resolve to enhance management transparency, on July 22 KT&G officially inaugurated its Corporate Governance Charter. Under the Charter, the first of its kind in Korea, the Company's board of directors is to comprise two-thirds outside directors to ensure independence from major shareholders and managers. The Company's efforts were recognized by Credit Lyonnais Securities Asia, which named its corporate governance structure among the top ten out of 380 Asian companies its surveyed in 2003, and by Standard & Poor's, which classified KT&G's corporate governance as "Strong."

Cigarette exports surge

The remarkable performance of overseas sales in 2003 saw exports of cigarettes jump 44.5% over the previous year to total 30.9 billion sticks. As of the end of 2003, exports accounted for more than 30% of total sales volume. In the year ahead, the Company intends to consolidate its success overseas by strengthening global brand recognition, continuing to develop Eastern European markets, and expanding its presence in China.

Yeongju factory completed

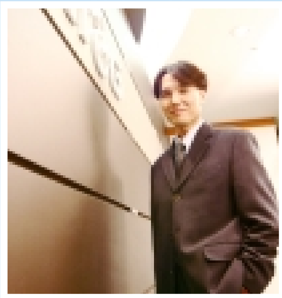
In June, the Company celebrated the completion of a new manufacturing plant at Yeongju. Under construction for two and a half years, the newly completed factory, which has an annual production capacity of 22 billion sticks, raises the Company's total annual production capacity to 100 billion sticks.

KT&G Social Welfare Foundation established

On July 4, the Company commemorated the official launch of the KT&G Social Welfare Foundation, a charitable organization established to promote social welfare services in the community. The Foundation's major projects include funding of programs for the underprivileged, support for various social welfare organizations, medical assistance for patients suffering from serious health conditions, and other projects promoting social welfare. In addition to an initial contribution of W5.3 billion, KT&G donated an additional W15 billion during 2003.

Low tar brand "THE ONE" launched

On September 22, KT&G rolled out "THE ONE", a premium product that contains 1 mg of tar and 0.1 mg of nicotine. The new brand is a regular, 84mm-long cigarette featuring a high absorption carbon-composite filter and is packaged in a modern, octagonal-shaped hard pack. The name "THE ONE" refers to the 1mg of tar the cigarette contains. The product proved a big hit with customers, capturing 8% of market share within three months of its launch and fortifying KT&G's position in the growing premium low-tar cigarette market.



Responsibility :

At KT&G, we take seriously our responsibility to shareholders and stakeholders. Through transparent governance and clear corporate vision, we are inspiring the trust of both.

Responsibility

Corporate Governance

Since our privatization at the end of 2002, we have successfully enhanced corporate value and credibility through heightened transparency and strengthened corporate governance.

What corporate governance means at KT&G

The term corporate governance encompasses a variety of ideas and opinions. To some it is a system by which business are directed and controlled. To others it is a term for the way in which directors manage their responsibilities to shareholders. Still others interpret it as synonymous with shareholder democracy. To us, corporate governance means promoting fairness, transparency and accountability in order to enhance the creation of enterprise value.

A recognized leader in corporate governance

Our efforts to promote transparent management have been recognized by independent organizations both at home and abroad. In August, we ranked first among Korean companies for management transparency in a survey of 115 analysts from 26 securities companies conducted by Economy21, a respected domestic financial journal.

Overseas, for the second consecutive year the internationally renowned Credit Lyonnais Securities Asia placed us among the top ten of 380 companies in its survey of Asian corporate governance standards in 2003. In addition, Standard & Poor's classed our corporate governance as "Strong."

KT&G Corporate Governance Charter

On July 22, we raised the bar for standards of governance in corporate Korea when we became the first local corporation to publish a Charter of Corporate Governance. The Charter comprises 17 articles in five categories: protection of shareholders' rights, the board of directors, the auditing body, stakeholders, and public disclosure. The full text of our Corporate Governance Charter can be downloaded from our website at www.ktng.com

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

Outside directors

KT&G has one of the highest proportions of outside directors among Korean corporations, with 10 outside directors among its 13-member board. The high ratio of outside directors ensures the independence of the board from senior management and major shareholders, while also benefiting the Company from the expertise and experience of leading academics and professionals from a broad range of backgrounds.

Disclosure

At KT&G, we take seriously our responsibility to disclose corporate information in a timely, forthright, and accurate manner. We provide regular, detailed and accurate disclosure through quarterly reports and interim reports. In addition, to ensure ease of access, all information subject to disclosure is posted in English language on our website www.ktng.com.

Vision & Strategy

Our responsibility to shareholders includes devising and implementing effective strategies that will drive corporate value and keep us on course to achieve our goal of ranking among the tobacco industry's top five companies.

Maintain dominance of the domestic market

We are determined to maintain our dominance of the domestic market in the face of falling demand and increasing competition. We will continue to introduce differentiated brands that offer high profit margins and meet consumer demand for high quality products. Moreover, the restructuring of our product portfolio to focus on strategic brands will include the gradual phasing out non-profitable brands. We also intend to reinforce competitiveness through segmented marketing. We will conduct careful analysis of each market segment and devise appropriate strategies to improve product competitiveness. At the same time, we will continue to refine our brand management and enhance our channels of distribution nationwide.

Furthermore, we will be responsive to market demands, and continue to develop brands that meet consumers' increasing preference for low-tar and slim-type cigarettes. We will also seek optimal pricing strategy based on market research and analysis of the effects of tax increases on consumption. Through these measures, we are confident of meeting our targets for 2004 and remaining the leading player in the domestic market.

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

Reinforce cigarette export business

We have already established a strong presence in the Middle East and Central Asia. On the back of strong brand recognition of KT&G products, we will further expand our market share through strategic marketing and reinforcement of

Responsibility

premium brands in those markets. In addition, we aim to continue to expand into recently entered regions such as China and Japan, where the promotion of high-margin premium brands will increase market share and profit margins.

In 2004, we intend to improve further the profitability of export sales through a continued focus on premium brands and incremental increases in the average price per pack. By 2008, we aim to achieve an annual export target of 70 billion sticks and propel KT&G into the ranks of the world's top five tobacco companies.

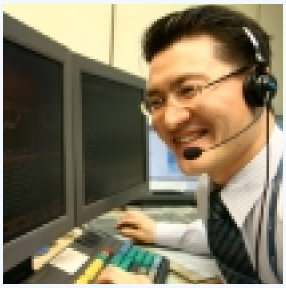
Secure quality management system

We will continue to seek ways to upgrade our management in order to lower costs and raise efficiency. In 2004, we aim to secure first-class manufacturing technology in line with the increasing importance in our product portfolio of high-quality premium brands. We will also follow up our successful rationalization program, which has resulted in significant gains in productivity, and implement effective cost-cutting measures. A continued reduction in the volume of domestic leaf tobacco, to be replaced by cheaper, imported raw material, will play an important role in lowering manufacturing costs. In addition, we will explore ways to promote efficiency through the ongoing modernization at production facilities. Furthermore, management restructuring will contribute to a more effective deployment of labor and will enhance operational efficiency throughout the organization. Backed by regular upgrading of employee skills through training and education, we will boost productivity levels and maintain the current trend of falling production costs.

Maximize Shareholder Value

As a recently privatized company, we are keenly aware of the need to meet our obligations to our shareholders. In 2004, we intend to go to greater lengths to maximize shareholder value. We will continue to abide by our stated aim of ethical management and maintain the independence of our board of directors. We intend to increase the scope and quality of our investor relations activities and will explore ways to improve the quality of our disclosure. Moreover, we aim to continue to retire treasury stocks and maintain our high dividend policy.

Cloud 9 :
A distinctive tasting premium brand with carbon compound filter and unique package.



Relationships:

By nurturing trusting relationships with our customers, shareholders, and employees, we have transformed KT&G into a successfully privatized company and a global force in the industry.

Relationships

Customers

KT&G's long history of forging successful business relationships at home has helped it nurture strong partnerships with customers overseas.

Domestic

With our long history as the nation's sole tobacco company, the relationships we enjoy with both trade and retail customers is unmatched by any of our competitors. In recent years, we have separated our distribution system from sales management in order to respond more effectively the challenges of a rapidly changing marketplace. Our extensive network of outlets currently encompasses more than 155,000 retailers nationwide who are served by staff at 144 branch offices and 12 regional headquarters.

One of the legacies of our years as a nationalized company is the unique relationship that we enjoy with the Korean public. Over the years, the names of dozens of our brands have gained a place in the national consciousness through memorable advertising campaigns. Today, we are building on the strength of our heritage as the nation's favorite tobacco company and appealing to new generations of consumers with quality products that are carefully tailored to their tastes.

Esse & Esse Lights :
Extra-long, super slim premium brands. Esse was introduced to the domestic market in 1996. Esse Lights, an ultra-low tar version, was launched in December 2002.

Overseas

Our rapid expansion into overseas markets, including those in Central Asia and the Middle East, has been achieved in part by developing close ties with local distributors and sales agents and by establishing brand recognition with consumers. We have been active in developing relationships by participating in regional industry forums and creating mutually beneficial relationships based on products that appeal to consumers in local markets. Moreover, we have rapidly gained high brand recognition with overseas customers through consistently high quality products backed by advertising campaigns tailored to regional markets.

Shareholders

KT&G is building lasting relationships with its shareholders through profit sharing and open channels of communication. The Company has consistently maintained a high-dividend policy, and has been applauded for the depth and breadth of its investor relations activities.

This Plus :

Originally introduced to the domestic market in 1999, the popular mid-priced brand was relaunched with a new look and taste in February 2003.

Creating shareholder value

At KT&G, we can confidently back our claim of providing maximum value by pointing to our remarkable record of returning profits to shareholders. In 2003, we returned a dividend of W1,600 per share, an increase of W200 on the KRW1,400 in 2002. The payout ratio was equivalent to over 48% of net profit in 2003. We have also taken other practical measures to boost the value of our shares. In 2002, we purchased and cancelled 5% of issued shares. In 2003, we purchased and cancelled a further 3 million shares, equivalent to 1.65% of issued shares. The Company's stock has provided total shareholder return of 33.9%, including a dividend yield of 7.7% over its year-end price in 2003.

Relationships

Investor relations

KT&G provides investors and analysts with timely and accurate financial information, disclosure items and market knowledge about the Company and the industry. The Company holds quarterly IR conferences for domestic investors and quarterly conference calls and non-deal roadshows for overseas investors. Its efforts were recognized in the results of a survey of analysts at 26 securities companies carried out by the domestic financial journal Economy21. All of the 115 respondents in the survey awarded KT&G top marks for the quality and variety of its IR activities.

Employees

At KT&G, we have a commitment to bringing out the best in every one of our employees, from the factory floor to the boardroom.

Not least among the relationships we value are those with our employees. At KT&G, we are creating a corporate environment that rivals that of any globally competitive company. We promote values aimed at encouraging inclusiveness among employees throughout the organization. As a result, we have fostered a dynamic workplace where initiative and excellence flourish.

We also continue to nurture our human resources by providing ongoing education and training. In addition, through the introduction of accountability and performance-based compensation, we have raised productivity throughout the organization. Reflecting our new status as a privately owned company, we also introduced a well-received employees stock ownership plan. With our innovative and progressive approach to the human dimension of the Company, we are creating a workplace that attracts and retains talented individuals who are contributing to our growth and success.

Reliability:

The KT&G name is renowned for more than the quality of its products. In communities at home and abroad, we are reliable partners to charitable institutes, humanitarian organizations and social welfare projects.

Reliability

In 2003, KT&G contributed more than W39 billion, equivalent to 8.4% of net income, to a variety of social welfare projects. Over the next four years, we plan to provide W100 billion in funding to the KT&G Social Welfare Foundation for social welfare programs and W21 billion in direct donations to projects including national heritage preservation, social welfare, and disaster relief.

KT&G Social Welfare Foundation

The KT&G Social Welfare Foundation was founded in July 2003 to provide a systematic and comprehensive framework for the Company to contribute to the community. Major projects undertaken by the Foundation include support for the underprivileged, financial aid for social welfare organizations, medical assistance for patients suffering from serious health conditions, and other projects that promote social welfare.

KT&G provided an initial contribution of W5.3 billion and additional funding of W15 billion during 2003. Over the next four years, we have pledged a further W46.6 billion, which will boost the Foundation's assets to W66.9 billion and rank it sixth largest among domestic charitable organizations. During the same period, we will donate a further W17.4 billion in working capital. Added to dividend income of W10.8 billion, the contribution will increase the Foundation's total working capital to W28.2 billion by 2007.

Support in the Community

Caring for Youth

We help to provide a better future for the youth of the nation through our support of the Korea Youth Protection Association. The Association provides underprivileged and abused young people with opportunities for vocational training and helps them to find employment opportunities.

KT&G scholarships

KT&G awards scholarships to deserving students at five high schools in the city of Daejeon. Through providing educational opportunities for disadvantaged students, we aim to foster an awareness among young people of the importance of social contribution and maintain a close relationship with our local community.

Support for Child Leukemia and Cancer Patients

After accidents, cancer is the major cause of death among children up to 16 years old. Through donations to the Korean Association for Children with Leukemia and Cancer in 2003, we provided medical expenses for 100 patients suffering from cancer and leukemia. We also operate a fully equipped mobile home where the families of child cancer

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

patients who live outside major cities can stay during treatment at specialized cancer centers in and around the capital city.

Support for World Alzheimer's Day

World Alzheimer's Day, held on 21 September each year, focuses on raising awareness of dementia, which affects an estimated 18 million people around the world. Through donations to the Community Chest of Korea and the Korea Alzheimer's Association, KT&G contributed to the global effort to bring dementia and the plight of its victims to the attention of governments, the media, and medical professionals around the globe.

Community Care Endowments

During 2003, KT&G provided W200 million in endowments to 33 domestic social welfare organizations. The funding focused on organizations that provide care for the elderly, particularly those who lack adequate medical care due to economi problems. In addition, funds were used to purchase equipment, material and daily necessities for well being for the elderly.

Pine :
A popular brand with a full tobacco flavor exported to the Middle East and Central Asia.

Reliability

Humanitarian Aid

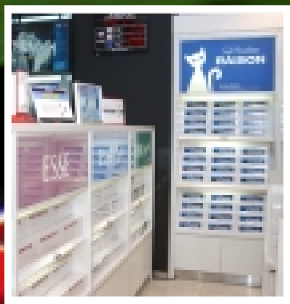
Relief Supplies to Iran

On December 26, 2003, an earthquake devastated the Iranian city of Bam and its surrounding area, leaving more than 35,000 dead and up to 100,000 homeless. As part of worldwide relief effort in response to the humanitarian tragedy, KT&G donated 11,520 blankets needed to provide protection against the severe the cold weather.

Oil stoves to Iraq and Afghanistan

Responding to the plight of the needy and homeless in Afghanistan and Iraq, KT&G provided funds of W150 million for the purchase of 2,000 oil stoves. In Afghanistan, 1,300 stoves were distributed in the Kabul area, while in Iraq 700 stoves were issued in areas where Korean peacekeeping troops were deployed.

Carnival :
A mild-tasting brand exported to America.



Performance in 2003

The successful launch of our new brands Raison, Seasons, and THE ONE, along with the continued growth of Esse, reinforced our strong position in the premium and low tar cigarette markets.

Performance in 2003

Domestic Sales

Despite weakening demand and strong competition, in 2003 KT&G achieved sustainable growth and raised profitability in the domestic market.

In 2003, KT&G maintained dominant market share and increased its profitability. The Company recorded domestic sales of 74.4 billion sticks, which accounted for about 77% of the local cigarette market. Domestic net sales also rose to W1.9 trillion in 2003.

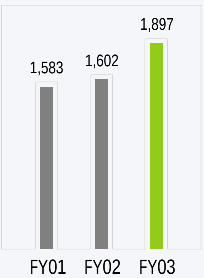
In addition to remaining the number one player in the local market, KT&G made notable progress in pegging back the expansion of competitors, whose aggressive marketing had increased their market share over the past few years. The Company's successful response to the challenge resulted chiefly from a continued restructuring of its product portfolio to focus on high-margin premium brands.

Since the year 2000, the portion of premium brands in the Company's portfolio has climbed continually. With the successful introduction of new brands such as Seasons, Time, Raison, and THE ONE, premium products accounted for 57% of total domestic sales volume in 2003. Supported by sophisticated brand management, a restructured marketing system, and an extensive distribution network, the new brands reinvigorated the Company's product line-up and played an important role in its successful performance for the year. They also contributed to raising profit margins in 2003, when the average selling price per pack rose by over 14% compared to the previous year. As a result, premium brands accounted for more than half of net operating revenue.

The Company also reinforced its competitiveness by responding rapidly to market trends and meeting the demands of consumers. Reflecting the rising priority of health concerns among the public, it successfully targeted the low tar market segment with the launch of premium brands, including Esse Light and THE ONE, while at the same time maintaining an unrivalled hold on the market for slim-type cigarettes.

Domestic Net Sales

(In billions of Korean Won)



Export Sales

KT&G's expansion into overseas markets has been as successful as it has been rapid, with exports more than quintupling over the past three years. In 2003, the Company maintained its impressive record and for the first time recorded a net profit in overseas operations.

Echoing the success of its domestic sales strategy, KT&G's shift towards premium brands has driven profitable growth of export sales. The Pine brand enjoyed strong brand recognition in the Middle East and Central Asia, while the premium brand Esse contributed to an improved brand mix and greater profitability. Based on the successful

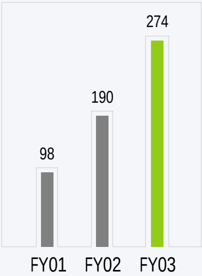
establishment of Pine and Esse, the Company plans to increase its penetration of overseas markets.

In 2003, total export sales volume surged by 44.5% over the previous year to total 30.9 billion sticks, which represented more than 30% of the Company's total cigarette sales. Underlining the importance of overseas markets, the value of exports in 2003 jumped by 52.8%. As a result of higher volume and improved profitability, in 2003 the Company's overseas business recorded its first net profit.

By region, the Company fortified its market presence in Central Asia and the Middle East. The two regions remained its most important international markets by some margin, with sales increasing to 84% of total export value. The Company also expanded its exports to Eastern Europe and Russia, and continued to advance into Southeast Asia and China, where it made progress in strengthening the brand recognition of Esse.

Export Revenue

(In billions of Korean Won)



Performance in 2003

Manufacturing

In 2003, KT&G continued facility rationalization an lowered raw material costs. It also raised efficiency and increased total production capacity.

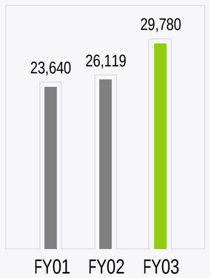
Over the past several years, the Company has implemented a systematic program of rationalization at its manufacturing and processing facilities. In 2002, it halted operations at one of its three leaf tobacco processing factories and one of its six manufacturing plants. It continued the trend in 2003 with the closure of its inefficient Suwon factory. However, overall production capacity increased to around 139 billion sticks annually with the completion of a new plant at Yeongju.

Along with closure of inefficient facilities, the Company has upgraded machinery and production systems at operational plants. In 2003, improved automation helped raise efficiency and lower the number of workers required on each production line. As a result, labor productivity jumped by an impressive 14.0%.

The Company also successfully lowered raw material costs by cutting back its usage of domestic leaf tobacco to 63% in 2003 from 67% in 2002. The contract volume of domestic leaf tobacco dropped 15.1% YoY to 44,000 tons in 2003. As a result, the Company reduced the purchase of domestic leaf tobacco during 2003 by 25.0% in volume and 23.3% in value.

Labor Productivity

(Stick / man-hour)



Financial Information

Management's Discussion & Analysis

(In billions of Korean won, except per share data)	2001	2002	2003	Change
Net sales	1,701.4	1,806.9	2,178.9	20.6%
Net income	333.8	347.4	459.7	32.3%
Total assets	3,670.5	3,916.2	4,013.4	2.5%
Total liabilities	1,054.6	1,764.1	1,198.1	-32.1%
Total shareholders' equity	2,615.9	2.152.1	2,815.3	30.8%
Operating margin (%)	26.4	29.2	32.7	3.5%p
Return on equity (%)	12.4	14.6	18.5	3.9%p
Interest-bearing debt to equity (%)	11.9	51.6	17.4	-34.2%p
Number of shares outstanding, year-end (000's) (1)	167,274	119,568	138,455	15.8%
Number of shares outstanding, average (000's)	179,718	146,989	123,428	-16.0%
Earnings per share (won)	1,858	2,364	3,724	57.5%
Diluted earnings per share (won) (2)	1,841	2,084	3,307	58.7%
Average dividend per share (won)	1,267	1,400	1,600	14.3%
Year-end stock price (won)	19,400	16,400	20,700	26.2%
Year-end KOSPI index (point)	693.7	627.6	810.7	29.2%
Average net selling price (won/pack of 20 cigarettes)	379.6	441.4	505.6	14.5%
Domestic sales volume (in billions of cigarettes)	83.4	72.5	74.4	2.6%
Exports volume (in billions of cigarettes)	11.6	21.4	30.9	44.5%
Number of employees	4,426	4,635	4,564	-1.5%

1) # of shares outstanding = # of shares issued - # of treasury stocks (refer to financial statements note 21) 2) Refer to financial statements note 26

Management's discussion and analysis may contain forward-looking statements that are provided to assist in the understanding of anticipated financial performance. Words such as "plans", "anticipates", "expects", and similar expression are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those expressed in such statements. The term "the Company" used here without any other qualifying description will refer to "KT&G."

While business challenges were plentiful with a tough economy, a volatile political environment, and the impact of Iraq War and SARS, KT&G reported its best ever performance in 2003, the first year of privatization. In spite of sluggish domestic demand, the spread of an antismoking campaign and severe competition, the Company achieved sustainable growth and profitability improvement, maintaining its dominant market leadership at home. In the domestic market, the Company led the premium and low tar cigarette segment. In addition, the Company achieved another remarkable success in overseas business, fortifying its market presence in Central Asia and the Middle East and further expanding its export base in Eastern Europe and Russia. Overall, taking into account the limited growth potential of the global tobacco industry, the Company's operating and financial performance in 2003 was a great success.

Analysis of Operating Results

Summary Income Statement

(In billions of Korean won)

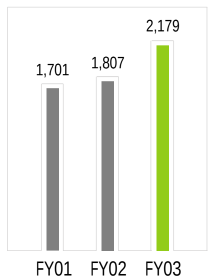
	FY01	FY02	FY03
Gross sales	4,713	4,874	5,457
Net sales	1,701	1,807	2,179
Operating income	449	527	711
Net income	334	347	460
Earnings per share (won)	1,858	2,364	3,724

Sales

Leadership in the low tar cigarette market, preservation of its domestic market share, average price increase through higher margin brand mix and market diversification into the overseas markets were core growth drivers. KT&G managed these strategic variables by successfully maintaining current domestic market share, proactively proceeding into new foreign markets and consistently improving sales mix at home and abroad. As a result, the Company has sustained its top line growth.

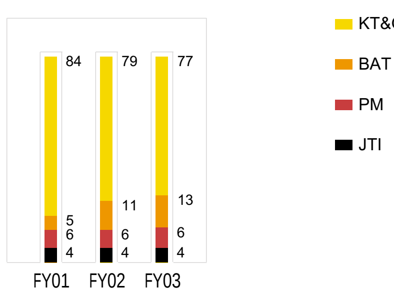
In 2003, net sales surged 20.6% YoY to KRW2,179 billion, while gross sales increased 12.0% YoY to KRW5,457 billion. Gross sales are the sum of net sales and tobacco excise taxes and dues. Tobacco taxes and dues for all but one exception total to a fixed KRW929 a pack. For cigarette products sold at KRW200 or lower a pack, tobacco excise taxes and dues are KRW60. As high-margin premium brands contribute more to gross sales, the portion of net sales over gross sales rose from 36.1% in 2001 to 39.9% in 2003.

Net sales (In billions of Korean Won)



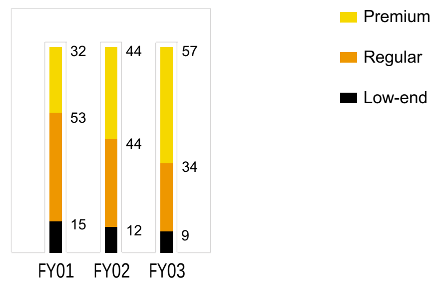
The Company has gradually been losing domestic market share, affected by domestic demand slowdown for cigarettes and aggressive marketing efforts by competitors. Recently, however, the Company safeguarded its domestic market share at around 77% as of the end of 2003 on the back of the launching of low-tar premium brands and an unchallenged market position in the slim-type cigarette segment. In addition, accompanying with incomparably strong marketing and distribution network, implementation of new marketing system helped KT&G to preserve its lion's share in the domestic market.

Domestic market share (%)

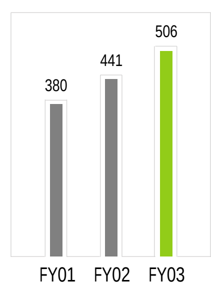


In addition, the Company has continuously shifted toward premium brands and introduced efficient brand management tools to nurture some strong representative brands such as 'Esse', 'Time', 'Raison', and 'THE ONE'. Its brand mix has changed substantially, and premium brands dominated, accounting for over 55% of domestic sales volume. In tandem with the high contribution of premium brands, the weighted average net selling price per pack jumped 14.6% YoY to KRW505.6 in 2003 from KRW441.4 in 2002.

Brand mix (%)



Average net selling price per pack (Korean Won per pack)

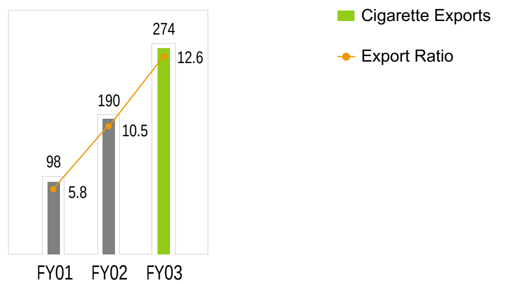


As growth potential in the domestic market is inevitably limited in the longterm, overseas markets offer a very important source of future volume growth. Cigarette exports more than quintupled over the past three years. In 2003, exports, in terms of volume, soared 44.5% YoY to 30.9 billion cigarettes, accounted for more than 25% of total cigarette sales volume. Meanwhile, cigarette exports, in terms of value, surged 52.8% as brand reshuffle toward premium products was carried out in exports, also. By region, exports to Central Asia and the Middle East propelled the export growth. In addition, the Company further expanded its export base in Eastern Europe and Russia and continued to

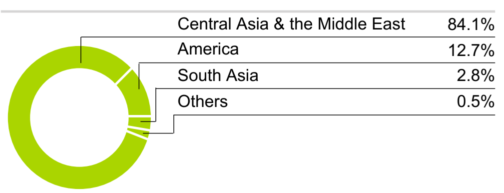
Management's Discussion & Analysis

advance into Southeast Asian and China markets where it is establishing 'Esse' as a global brand.

Cigarette exports (In billions of Korean Won, %)



Export revenue by region (%)

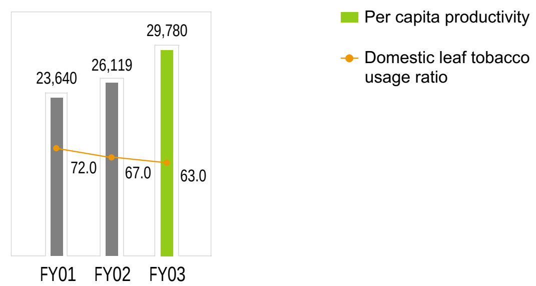


Separately, to cope with a possible hike in tobacco taxes and dues, the Company will continue to drive marketing efforts, cease the production of unprofitable brands, lower domestic leaf tobacco usage, and increase net selling price through premium brands. Also, the Company will improve asset utilization through the development of idle real estate.

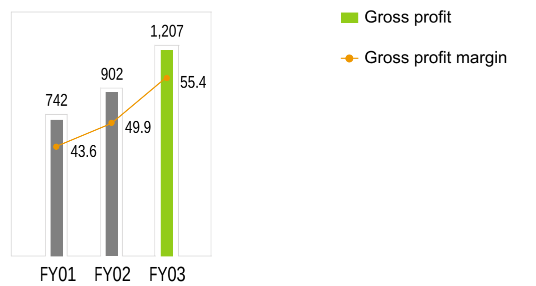
Operating Cost and Expenses

COGS increased by 7.4% YoY to KRW972 billion compared to KRW906 billion a year ago due to production volume growth. However, the 5.5%p drop in the ratio of cost of sales over net sales to 44.6% last year from 50.1% in 2002 was the major booster, primarily driven by lowering usage of domestic leaf tobacco to 63% in 2003 from 67% in 2002. Also, per capita productivity improved by 14.0% from 26,119 cigarettes per man-hour in 2002 to 29,780 cigarettes per man-hour in 2003. As a result, the gross profit margin rose to 55.4% in 2003 from 49.9% in 2002; gross profit increased 33.9% YoY to KRW1,207 billion in 2003.

Cost of sales (cigaretee/m/h, %)



Gross profit and margin (In billions of Korean Won, %)



SG&A expenses rose 32.3% YoY to KRW496 billion in 2003 compared to KRW375 billion previous year, nudging up the ratio of SG&A expenses over net sales by 2.1%p to 22.8% last year. In particular, salaries and advertising expenses swelled, responsible for over 60% of increase in SG&A expenses. Advertising expenses climbed 77.6% or KRW59 billion to KRW135 billion in 2003 for the following reasons: launches of new premium brands such as 'THE ONE' and 'Cloud 9', execution of segmental marketing practices, extensive public relations activities due to the change in corporate identity, and aggressive overseas marketing activities. In addition, salaries increased 9.8% YoY or KRW15 billion to KRW169 billion last year. As the Company granted performance-based incentive payments (a total of 1,345,664 shares, equivalent to KRW28 billion) to employees in 2003 upon the outperformance of its business goal, employee welfare soared to KRW31 billion last year from KRW13 billion in 2002. Employees are obliged to sell those shares over the next four years.

SG&A expenses breakdown

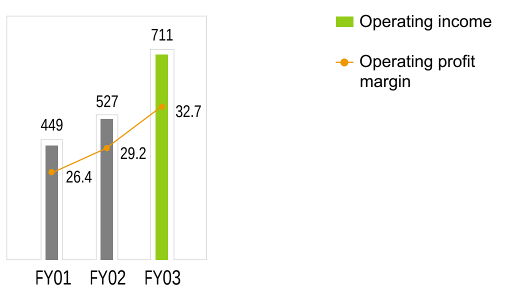
(In billions of Korean won)

SG&A Expenses	FY01	FY02	FY03
Salaries	128	154	169
Employee welfare	11	13	31
Advertising	45	76	135
Commissions	16	31	37
Depreciation	22	28	33
Others	71	73	91

Operating Profit Margin

Operating profit margin gained 3.5%p in 2003 to record 32.7% compared to 29.2% a year earlier. Expansion of cheap imported leaf tobacco usage and premium brand sales was the major profit booster, in addition to the productivity gain. Overall, improvement in gross profit overwhelmed growth in SG&A expense, elevating operating profit by 35.0% YoY to KRW711 billion in 2003 from KRW527 billion previous year.

Operating profit & margin (In billions of Korean Won, %)

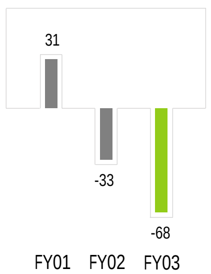


Non-operating Items

In 2003, non-operating income and expenses soared 44.8% YoY to KRW185 billion and 56.6% YoY to KRW252 billion, respectively, resulting in deterioration of net non-operating expenses. The Company posted net non-operating expenses of KRW68 billion in 2003.

Non-operating income rose on the back of an increase in equity income from Korea Ginseng Corporation. In addition, the Company recorded KRW15 billion of valuation gain on interest rate swaps. KT&G had three currency swap and two interest rate swap contracts to match cash outflows from convertible bonds with cash inflows from investments in bonds.

Net non-operating income (In billions of Korean Won)



Non-operating expenses jumped due to losses on bond conversion, increases in interest expenses, evaluation losses on inventories, donations, and provision for tobacco production stabilization fund. As a result, net non-operating balance further deteriorated, posting non-operating expenses of KRW68 billion in 2003.

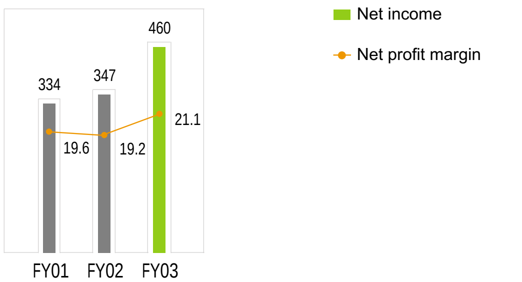
Earnings and Dividends

Due to a sharp rise in non-operating expenses, increase in pretax income fell a little short compared to the surge in operating profit. Pretax profit jumped 30.5% YoY to KRW644 billion in 2003 from KRW494 billion previous year and pretax profit margin gained 2.2%p to 29.6% in 2003. In particular, the margin improvement in pretax profit was almost fully transferred to net profit margin as the effective tax rate further declined from 29.6% in 2002 to 28.6% in 2003; net profit margin improved by 1.9%p to 21.1% last year. The Company recorded a historic high net profit of KRW460 billion in 2003 up 32.3% YoY, and its ROE improved from 14.6% in 2002 to 18.5% in 2003. Its earnings per share increased 57.5% YoY to KRW3,724 last year, and the resulting price-to-earnings ratio (based on the share price of KRW20,700 as of the end of 2003) stood at 5.6 times. Separately, the diluted earnings per share increased 58.7% YoY to KRW3,307 in 2003, and diluted price-to-earnings ratio stood at 6.3 times.

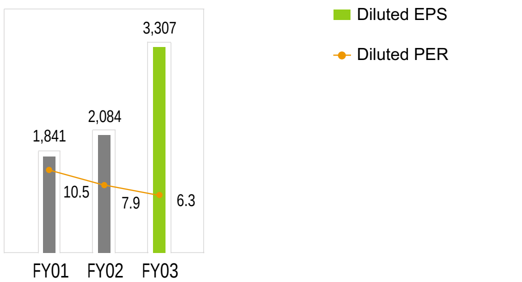
The Company has not only done its best to maximize shareholders' value but also practically returned profits to shareholders. KT&G purchased and retired treasury stocks in the previous year and paid out 48.2% of 2003 net profit as dividend. 2003 dividend per share was KRW1,600, compared to KRW1,400 in 2002. Its dividend yield over the year-end stock price came up to 7.7%.

Management's Discussion & Analysis

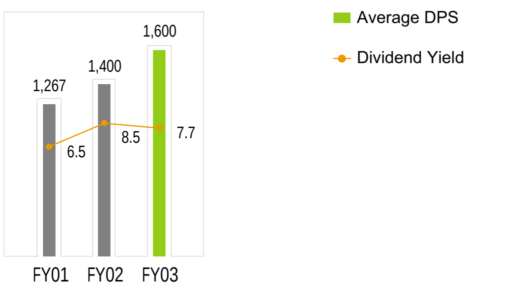
Net profit margin (In billions of Korean Won, %)



Diluted PER and diluted EPS (In Korean Won, X)



Dividend yield & dividend per share (In Korean Won, %)



Analysis of Financial Condition

The Company considers its strong financial position and financial flexibility to be a competitive advantage. This advantage is based on strong and solid operating cash flows, a commitment to cash discipline regarding working capital and capital expenditures, and the intent to pursue a fiscally responsible policy of maximizing shareholders' value.

Summary Balance Sheet

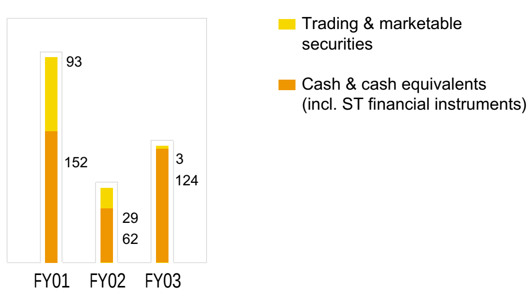
(In billions of Korean won)

	FY01	FY02	FY03
Assets	3,671	3,916	4,013
Liabilities	1,055	1,764	1,198
Interest-bearing debt	314	1,110	489
Total shareholders' equity	2,616	2,152	2,815

Cash and Marketable Securities

Cash, cash equivalents and marketable securities as of December 31, 2003 jumped by KRW36 billion to KRW127 billion, from KRW91 billion at the end of 2002, powered by strong net profit growth and efficient working capital management. On the back of abundant cash inflows from operating activities, the Company continued to preserve shareholders' value by purchasing treasury stocks and remove financial uncertainty by reducing marketable securities

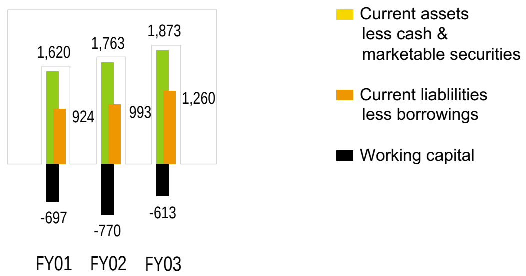
Cash & marketable securities (In billions of Korean Won)



Working Capital

KT&G defines working capital as the difference between current assets less cash and marketable securities and current liabilities less borrowings. The Company's working capital requirements increased by KRW141 billion to KRW1,260 billion at December 31, 2003 from KRW993 billion at the end of 2002. On the back of efficient working capital management, the portion of working capital over total operating revenues remained stable at 20.8% in 2003, compared to 20.4% in 2002.

Working capital (In billions of Korean Won)



Fixed Assets

Investment assets increased 5.3% YoY to KRW972 billion at year-end 2003 compared to KRW923 billion at the end of 2002, attributable to a KRW53 billion increase in investment securities. Meanwhile, long-term loans to employees declined to to KRW120 billion at the end of 2003 from KRW144 billion at December 31, 2002.

The year-end balance of property, plant and equipment (PP&E) edged up slightly by KRW28 billion or 2.5% YoY to KRW1,166 billion in 2003 due mainly to capital expenditure on facility maintenance and rationalization. Upon the completion of the Yeongju factory project, depreciation expenses on PP&E increased 9.7% YoY to KRW87 billion in 2003 from KRW79 billion in 2002. Intangible assets jumped 23.6% YoY to KRW2.5 billion at the end of 2003 from KRW2.0 billion at the end of 2002.

Fixed assets

(In billions of Korean won)

	FY01	FY02	FY03
Investment assets	811	923	972
Property, plant & equipment	992	1,138	1,166
Intangible assets	2	2	2

Debt Financing

Abundant operating cash flows and conversion of convertible bonds into stocks enabled KT&G to reduce its interest-bearing debt substantially. The Company cleared the balance of short-term borrowings, paying down KRW290 billion in 2003. In addition, domestic convertible bonds amounting to KRW345 billion were converted into 19,346,467 shares of treasury stock last year. As a result, total interest-bearing debt fell sharply by KRW621 billion or 56.0% YoY to KRW489 billion at the end of 2003.

Borrowings & debt-to-equity ratio

(In billions of Korean won, %)

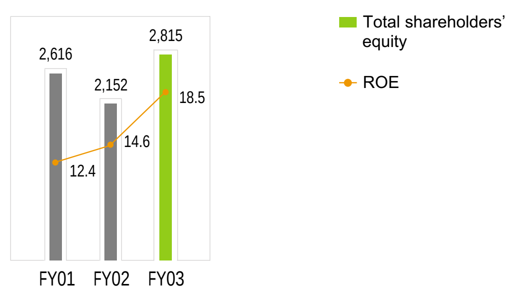
	FY01	FY02	FY03
Short-term borrowings	0	290	0
Exchangable bonds	314	820	489
Interest-bearing debt-to-equity ratio	11.9	51.6	17.4

Shareholders' Equity

Total shareholders' equity surged to KRW2,815 billion at year-end 2003 compared to KRW2,152 billion at the end of 2002 due mainly to increases in capital surplus and retained earnings. While capital stock remained the same, capital surplus rose significantly to KRW81 billion at December 31, 2003 because of disposal of treasury stocks by redemption of exchangeable bonds, and retained earnings increased to KRW2,517 billion at December 31, 2003 from KRW2,292 billion at year-end 2002. Separately, offset in capital adjustments amounted to KRW738 billion as of December 31, 2003.

Despite the increase in shareholders' equity, the 32.3% rise in net profit boosted ROE by 3.9%p to 18.5% in 2003 compared to 14.6% a year earlier.

Total shareholders' equity (In billions of Korean Won, %)



Analysis of Cash Flows

Summary Cash Flows Statement

(In billions of Korean won)

	FY01	FY02	FY03
Cash flows from operating activities	-52	451	635
Cash flows from investing activities	152	-203	-61
Cash flows from financing activities	-172	-229	-508

Management's Discussion & Analysis

Cash provided by operating activities

(In billions of Korean won)

	FY01	FY02	FY03
Net profit	333.8	347.4	459.7
Depreciation and amortization	73.1	79.7	87.4
Others	-458.6	24.3	87.9

Cash flows from operating activities showed solid growth of 40.7% to net inflow of KRW635 billion in 2003 compared to net inflow of KRW451 billion in the previous year. In addition to strong cash inflows from net profit and depreciation, cash inflows from others also increased.

Cash used in investing activities

(In billions of Korean won)

	FY01	FY02	FY03
Net capital expenditure	-105.4	-224.6	-126.5
Maketable securities	472.5	41.1	32.4
Others	-214.7	-19.5	33.6

Cash flows from investing activities, on the other hand, improved to net outflow worth KRW61 billion in 2003 from net outflow of KRW203 billion in 2002. Upon the completion of new plant construction in Yeongju, net capital expenditure almost halved to KRW127 billion in 2003 compared to KRW225 billion in 2002.

Cash used in financing activities

(In billions of Korean won)

	FY01	FY02	FY03
Borrowings & debentures	312.0	784.0	-289.6
Dividend	-206.1	-212.0	-167.4
Others	-277.5	-801.2	-50.9

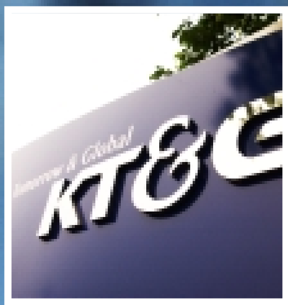
Net cash outflow from financing activities magnified to KRW508 billion in 2003 compared to KRW229 billion in 2002. Net purchase of treasury stocks and dividends paid amounted to KRW51 billion and KRW167 billion in 2002, respectively. At the same time, the Company paid down short-term borrowings of KRW290 billion in 2003.

2004 Business Outlook & Management Issues

The domestic demand for cigarettes, which showed temporary recovery last year, is expected to contract in 2004. In contrast, the market for premium low tar cigarettes will continue to grow steadily. Similarly, while KT&G's market share is expected to edge down due to intensifying competition in the domestic cigarette market, the extent of the decline should slowdown substantially to 1 to 2 percentage points. KT&G's various premium cigarette brands have been well received in the domestic market, positioning the Company at the front of the premium low tar cigarette segment.

In 2004, in accordance with such trends, the company's domestic average net selling price will continue to increase to KRW536.6 per pack. In addition, the company plans to achieve domestic and export sales volume of 71.3 billion and 35.0 billion cigarettes, respectively. As a result, net operating revenues will rise 9.5% YoY to KRW2,385 billion in 2004 with net profit reaching KRW520 billion, a 13.1% increase from the previous year.

Meanwhile, the negative effects of highly probable increases in tobacco taxes and dues will likely differ according to the magnitude and period of the increase. In particular, a decrease in domestic demand due to large tax hike remains a possibility. Moreover, intensified competition and the company's premium products-oriented marketing activities will increase its advertising expenses. However, in spite of such uncertainties surrounding the company, KT&G will continue its efforts to improve profitability through increases in average net selling price and continuous growth and profitability improvement in exports.



Financial Statements

Balance Sheets

December 31, 2003 and 2002

	Korean Won	U.S. Dollars (note2)	Korean Won
ASSETS	2003		2002
Current assets:			
Cash and cash equivalents (notes 3 and 17)	W 121,485,603,336	$ 101,423,947	W 54,912,699,155
Short-term financial instruments (notes 5 and 17)	2,095,438,087	1,749,406	6,737,430,709
Trading securities (notes 8 and 17)	2,892,636,827	2,414,958	-
Marketable securities (note 8)	-	-	29,258,498,191
Notes and accounts receivable - trade,			
less allowance for doubtful accounts of			
W 1,544 million in 2003 and W 1,188 million in 2002 (note 17)	152,905,095,264	127,654,947	117,604,047,478
Notes and accounts receivable - other,			
less allowance for doubtful accounts of			
W 2,666 million in 2003 and W 941 million in 2002	20,127,331,897	16,803,583	660,058,600
Current portion of long-term loans,			
less allowance for doubtful accounts of			
W 32 million in 2003 and 2002			
and present value discounts of W 247 million in 2003 and 2002 (note 11)	3,121,684,329	2,606,182	3,121,039,050
Inventories (notes 6 and 27)	1,399,131,038,503	1,168,084,019	1,435,448,055,084
Other current assets (note 7)	171,346,728,789	143,051,201	205,998,087,702
Total current assets	1,873,105,557,032	1,563,788,243	1,853,739,915,969
Investment and other assets:			
Available-for-sale securities (notes 8 and 17)	364,747,042,520	304,384,689	-
Investment securities (notes 8 and 9)	-	-	650,806,934,737
Investment securities accounted for under equity method (note 9)	338,925,613,429	282,956,765	-
Long-term loans, less allowance for			
doubtful accounts of W 747 million in 2003			
and W 695 million in 2002 and present value			
discounts of W 43,075 million in 2003			
and W 51,745 million in 2002 (note 11)	73,977,671,316	61,761,289	68,760,421,616
Long-term deposits in escrow fund,			
less allowance for doubtful accounts of			
W 17,137 million in 2003 and			
W 16,220 million in 2002 (notes 4, 17 and 29)	-	-	-
Other assets (notes 10 and 14)	194,458,383,829	162,475,744	203,184,925,096
Total investment and other assets	972,108,711,094	811,578,487	922,752,281,449
Property, plant and equipment, at cost (notes 12 and 27)	1,723,563,536,626	1,438,941,006	1,673,368,554,101
Less accumulated depreciation	(557,889,037,784)	(465,761,428)	(535,711,059,333)
Net property, plant and equipment	1,165,674,498,842	973,179,578	1,137,657,494,768
Intangible assets	2,497,663,507	2,085,209	2,021,217,512
Total assets	W 4,013,386,430,475	$ 3,350,631,517	W 3,916,170,909,698

Balance Sheets, *Continued*

December 31, 2003 and 2002

Liabilities and Stockholders' Equity	Korean Won 2003	U.S. Dollars (note2) 2003	Korean Won 2002
Current liabilities:			
Accounts payable - trade (notes 10 and 17)	W 10,510,359,657	$ 8,774,720	W 17,067,259,930
Accounts payable - other	22,435,957,756	18,730,972	30,496,062,069
Short-term borrowings	-	-	290,000,000,000
Advance receipts (note 24)	38,448,312,050	32,099,109	29,754,220,541
Withholdings	8,089,624,968	6,753,736	6,434,101,394
Value added tax payable	112,808,663,550	94,179,883	95,890,047,050
Tobacco excise taxes and dues payable (note 18)	278,960,326,930	232,893,911	310,854,715,776
Income taxes payable	124,035,692,168	103,552,924	93,620,616,289
Other current liabilities (notes 10, 17 and 19)	18,089,749,212	15,102,479	18,591,913,513
Total current liabilities	613,378,686,291	512,087,734	892,708,936,562
Long-term liabilities:			
Convertible bonds,			
plus long-term accrued interest expense of			
W 27,512 million in 2003 and W 16,324 million in 2002 and			
net of discount of W 4,235 million in 2003			
and W 6,534 million in 2002 (notes 15 and 17)	488,604,279,733	407,918,083	819,875,017,918
Retirement and severance benefits, net (notes 4 and 16)	40,597,310,132	33,893,229	27,638,545,178
Guarantee deposits received (note 10)	24,273,243,335	20,264,855	23,888,521,181
Deferred income tax liabilities (note 25)	11,611,128,867	9,693,712	-
Provision for the tobacco production			
stabilization fund (note 29)	19,589,041,095	16,354,184	-
Total long-term liabilities	584,675,003,162	488,124,063	871,402,084,277
Total liabilities	1,198,053,689,453	1,000,211,797	1,764,111,020,839
Stockholders' equity:			
Common stock of W 5,000 par value Authorized - 800,000,000 shares			
Issued - 178,442,497 shares (note 20)	954,959,485,000	797,261,217	954,959,485,000
Capital surplus	81,139,754,421	67,740,653	1,485,468,925
Retained earnings (note 22)	2,517,043,853,457	2,101,389,091	2,291,873,768,062
Capital adjustments:			
Treasury stock (note 21)	(744,775,812,070)	(621,786,452)	(1,102,637,693,342)
Gain on valuation of available-for-sale securities (note 8)	6,965,460,214	5,815,211	-
Gain on valuation of investment securities (note 8)	-	-	6,378,860,214
Total stockholders' equity	2,815,332,741,022	2,350,419,720	2,152,059,888,859
Commitments and contingencies (notes 28 and 29)			
Total liabilities and stockholders' equity	W 4,013,386,430,475	$ 3,350,631,517	W 3,916,170,909,698

See accompanying notes to financial statements.

Statements of Income

For the years ended December 31, 2003 and 2002

	Korean Won	U.S. Dollars (note2)	Korean Won
	2003		2002
Gross sales:			
Tobacco sales	W 5,432,211,762,077	$ 4,535,157,591	W 4,856,403,755,784
Export of leaf tobacco	8,263,773,870	6,899,126	14,807,390,048
Revenue from sales in lots & merchandise sales	16,296,548,466	13,605,400	2,816,876,344
Gross sales	5,456,772,084,413	4,555,662,117	4,874,028,022,176
Less : tobacco excise taxes and dues (note 18)	3,277,896,077,154	2,736,597,159	3,067,109,972,185
Net sales	2,178,876,007,259	1,819,064,958	1,806,918,049,991
Cost of sales (notes 24, 30, 31 and 32)	971,506,671,064	811,075,865	904,935,929,478
Gross profit	1,207,369,336,195	1,007,989,093	901,982,120,513
Selling and administrative expenses			
(notes 10, 30, 31, 32 and 34)	495,912,137,920	414,019,150	374,923,340,595
Operating income	711,457,198,275	593,969,943	527,058,779,918
Other income (expenses):			
Interest income	31,596,915,047	26,379,125	31,150,488,194
Interest expense	(40,981,744,471)	(34,214,180)	(31,847,102,590)
Gain on valuation of short-term financial			
instruments (note 5)	38,229,274	31,916	38,058,026
Loss on valuation of currency swaps (note 29)	(646,254,276)	(539,534)	(2,264,603,151)
Gain on valuation of interest rate swaps (note 29)	14,516,361,326	12,119,186	12,598,252,054
Rental income	10,426,652,133	8,704,836	8,864,033,949
Gain on sale of trading securities	5,994,453,421	5,004,553	-
Gain on valuation of trading securities	26,485,202	22,112	-
Gain on sale of marketable securities, net	-	-	1,673,278,004
Loss on valuation of marketable securities (note 8)	-	-	(24,316,028,120)
Loss on valuation of inventories	(22,676,469,997)	(18,931,766)	(12,583,292,157)
Other bad debts expense	(18,502,988,144)	(15,447,477)	(12,336,317,630)
Loss on foreign currency transactions, net	(2,086,730,058)	(1,742,135)	(3,577,997,812)
Gain (loss) on foreign currency translation, net	164,273,394	137,146	(20,769,865,595)
Donations (note 31)	(42,710,425,970)	(35,657,394)	(20,307,253,416)
Provision for Tobacco Production			
Stabilization Fund (note 29)	(19,589,041,095)	(16,354,184)	-
Gain on valuation of investments using			
equity method (note 9)	66,289,056,618	55,342,341	27,523,790,454
Gain on sale of property and equipment, net	9,487,824,413	7,921,042	5,849,249,342
Equipment impairment loss	(13,956,088,019)	(11,651,434)	-
Income tax refunds	358,264,851	299,102	678,314,400
Honorary retirement allowance	(4,386,025,860)	(3,661,735)	(2,602,294,860)
Available-for-sale securities impairment loss (note 8)	(1,777,049,932)	(1,483,595)	-

Statements of Income, *Continued*

For the years ended December 31, 2003 and 2002

	Korean Won	U.S. Dollars (note2)	Korean Won
	2003		2002
Loss on redemption of convertible bonds, net	(67,940,096,124)	(56,720,735)	(65,118,452)
Other, net	28,853,586,645	24,088,818	8,836,785,404
	(67,500,811,622)	(56,353,992)	(33,457,623,956)
Income before income taxes	643,956,386,653	537,615,951	493,601,155,962
Income taxes (note 25)	184,255,569,618	153,828,326	146,157,082,092
Net income	W 459,700,817,035	$ 383,787,625	W 347,444,073,870
Basic earnings per share (note 26)	W 3,724	$ 3.11	W 2,364
Net earnings per share (note 26)	W 3,724	$ 3.11	W 2,364
Diluted ordinary earnings per share (note 26)	W 3,307	$ 2.76	W 2,084
Diluted net earnings per share (note 26)	W 3,307	$ 2.76	W 2,084

See accompanying notes to financial statements.

Statements of Appropriation of Retained Earnings

For the years ended December 31, 2003 and 2002
Date of Appropriation for 2003: March 19, 2004
Date of Appropriation for 2002: March 14, 2003

	Korean Won	U.S. Dollars (note2)	Korean Won
	2003		2002
Unappropriated retained earnings:			
Balance at beginning of year	W 40,733,474,636	$ 34,006,908	W 26,395,531,197
Retirement of treasury shares (note 20)	(67,135,824,240)	(56,049,277)	(168,087,759,560)
Net income	459,700,817,035	383,787,625	347,444,073,870
Balance at end of year	433,298,467,431	361,745,256	205,751,845,507
Transfer from voluntary reserves:			
Reserve for technology development	17,888,673,340	14,934,608	11,619,591,000
Reserve for overseas business losses	193,540,346	161,580	193,540,360
Reserve for oversea market development	235,384,225	196,514	428,924,606
Reserve for energy saving facilities	131,147,225	109,490	134,480,563
	18,448,745,136	15,402,192	12,376,536,529
Unappropriated retained earnings			
Before appropriation	451,747,212,567	377,147,448	218,128,382,036
Appropriation of retained earnings:			
Cash dividends (note 23)	(221,527,870,400)	(184,945,626)	(167,394,907,400)
Other	-	-	(10,000,000,000)
	(221,527,870,400)	(184,945,626)	(177,394,907,400)
Unappropriated retained earnings to be			
carried over to subsequent year	W 230,219,342,167	$ 192,201,822	W 40,733,474,636

See accompanying notes to financial statements.

Statements of Cash Flows

For the years ended December 31, 2003 and 2002

	Korean Won	U.S. Dollars (note2)	Korean Won
	2003		2002
Cash flows from operating activities:			
Net income	W 459,700,817,035	$ 383,787,625	W 347,444,073,870
Adjustments to reconcile net income to net cash			
provided by operating activities:			
Depreciation	86,918,304,125	72,564,956	79,233,831,013
Amortization	525,276,740	438,535	472,026,682
Loss on valuation of inventories	22,676,469,997	18,931,766	12,583,292,157
Bad debts expense	356,576,239	297,693	678,139,769
Gain on valuation of trading securities	(26,485,202)	(22,112)	-
Gain on sale of trading securities	(5,994,453,421)	(5,004,553)	-
Loss on valuation of marketable securities	-	-	24,316,028,120
Gain on sale of marketable securities, net	-	-	(1,673,278,004)
Interest expense	22,083,983,592	18,437,121	15,530,073,463
Gain on valuation of investments using			
equity method	(66,289,056,618)	(55,342,341)	(27,523,790,454)
Loss on foreign currency translation, net	80,027,129	66,812	20,430,023,619
Other bad debts expense	18,502,988,144	15,447,477	12,336,317,630
Provision for retirement and severance benefits	32,766,712,551	27,355,746	24,929,889,133
Gain on sale of property, plant, & equipment, net	(9,487,824,413)	(7,921,042)	(5,849,249,342)
Interest income	(8,825,663,522)	(7,368,228)	(8,236,458,495)
Gain on valuation of short-term financial instruments	(38,229,274)	(31,916)	(38,058,026)
Loss on valuation of currency swaps	646,254,276	539,534	2,264,603,151
Gain on valuation of interest rate swaps	(14,516,361,326)	(12,119,186)	(12,598,252,054)
Loss on redemption of convertible bonds, net	67,940,096,124	56,720,735	65,118,452
Available-for-sale securities impairment loss	1,777,049,932	1,483,595	-
Provision for Tobacco Production Stabilization Fund	19,589,041,095	16,354,184	-
Equipment impairment loss	13,956,088,019	11,651,434	-
Repairs and maintenance	2,269,208,151	1,894,480	-
Other, net	(15,647,391,222)	(13,063,442)	908,231,740
Decrease (increase) in assets:			
Trade accounts receivable	(35,196,293,562)	(29,384,115)	(67,921,127,237)
Other accounts receivable	(21,161,319,262)	(17,666,822)	(263,762,272)
Accrued income	(50,468,667)	(42,134)	74,435,560
Advance payments	7,882,625,078	6,580,919	(15,295,126,947)
Prepaid expenses	(550,902,917)	(459,929)	260,365,930
Prepaid tobacco excise taxes and dues	23,502,618,574	19,621,488	(4,312,058,131)
Inventories	18,072,043,209	15,087,697	(54,396,885,033)
Deferred income tax assets	11,300,899,772	9,434,713	(8,578,250,691)

Statements of Cash Flows, *Continued*

For the year ended December 31, 2003 and 2002

	Korean Won	U.S. Dollars (note2)	Korean Won
	2003		2002
Increase (decrease) in liabilities:			
Trade accounts payable	(6,728,374,937)	(5,617,277)	9,448,794,777
Other accounts payable	(8,060,104,313)	(6,729,090)	29,136,687,161
Accrued interest expense	(121,266,002)	(101,241)	57,679,298
Advance receipts	8,694,091,509	7,258,383	20,338,320,466
Withholdings	1,655,523,574	1,382,137	(3,492,915,840)
Value added tax withholdings	16,918,616,500	14,124,742	2,968,086,970
Accrued expenses	379,487,319	316,820	(563,557,304)
Tobacco excise taxes and dues payable	(31,894,388,846)	(26,627,475)	40,721,168,626
Income taxes payable	30,415,075,879	25,392,449	18,169,933,659
Unearned income	(760,385,618)	(634,819)	100,443,915
Deferred income tax liabilities	11,611,128,867	9,693,713	-
Payments of retirement and severance benefits	(7,705,404,630)	(5,078,280)	(2,086,641,692)
Increase in severance benefits insurance deposit	(12,102,542,967)	(11,458,661)	(13,482,995,115)
Other, net	-	-	15,256,081,896
Net cash provided by operating activities	635,064,086,711	530,192,091	451,411,240,420
Cash provided by investing activities:			
Sale of short-term financial instruments	W 4,801,600,000	$ 4,008,683	W 116,655,450,271
Sale of trading securities	33,758,580,465	28,183,821	-
Sale of marketable securities	-	-	1,486,579,682,601
Sale of available-for-sale securities	174,075,000	145,329	-
Sale of investment securities	-	-	688,951,788
Sale of investment securities accounted for under equity method	50,000,000,000	41,743,196	-
Decrease in currency swaps	2,037,237,401	1,700,816	2,152,377,450
Decrease in interest rate swaps	6,360,137,280	5,309,849	4,943,546,286
Decrease in long-term loans employees	34,743,619,824	29,006,194	10,756,924,944
Decrease in guarantee deposits	21,654,977,955	18,078,960	6,284,043,563
Proceeds from sale of property, plant & equipment	29,079,078,954	24,277,074	13,794,157,014
Decrease in other investments	7,267,486,845	6,067,362	25,000,337,100
	189,876,793,724	158,521,284	1,666,855,471,017
Cash used in investing activities:			
Purchases of short-term financial instruments	(121,378,104)	(101,334)	(6,614,680,271)
Purchases of trading securities	(1,371,780,478)	(1,145,250)	-
Purchase of marketable securities	-	-	(1,445,500,000,000)

Statements of Cash Flows, *Continued*

For the year ended December 31, 2003 and 2002

	Korean Won	U.S. Dollars (note2)	Korean Won
	2003		2002
Purchases of available-for-sale securities	(29,283,317,500)	(24,447,585)	-
Purchase of investment securities	-	-	(23,410,320,432)
Purchase of securities under equity method	(8,903,204,190)	(7,432,964)	-
Increase in currency swaps	(6,905,599,998)	(5,765,236)	(6,905,599,998)
Increase in interest rate swaps	(5,658,619,455)	(4,724,177)	(5,094,069,254)
Increase in guarantee deposits	(26,411,792,229)	(22,050,252)	(12,858,253,924)
Increase in long-term loans to employees	(10,812,810,060)	(9,027,225)	(117,596,758,120)
Increase in long-term deposits in escrow fund	(655,917,465)	(547,602)	(11,941,132,161)
Increase in other investments	(3,711,402,173)	(3,098,516)	(863,035,900)
Purchases of property, plant & equipment	(155,605,478,652)	(129,909,400)	(238,350,139,585)
Purchases of intangible assets	(1,002,015,331)	(836,547)	(670,695,557)
	(250,443,315,635)	(209,086,088)	(1,869,804,685,202)
Net cash used in investing activities	(60,566,521,911)	(50,564,804)	(202,949,214,185)
Cash provided by financing activities:			
Increase in guarantee deposits received	29,299,071,670	24,460,738	1,022,769,417
Increase in short-term borrowings	-	-	290,000,000,000
Issuance of convertible bonds	-	-	492,957,846,323
Reissuance of treasury stock	16,221,348,867	13,542,619	16,152,500,000
	45,520,420,537	38,003,357	800,133,115,740
Cash used in financing activities:			
Repayment of short-term borrowings	(290,000,000,000)	(242,110,536)	-
Decrease in guarantee deposits received	(28,914,349,516)	(24,139,547)	-
Reacquisition of treasury stock	(67,135,824,240)	(56,049,277)	(817,365,941,829)
Dividends paid	(167,394,907,400)	(139,751,968)	(212,015,635,650)
	(553,445,081,156)	(462,051,328)	(1,029,381,577,479)
Net cash used in financing activities	(507,924,660,619)	(424,047,971)	(229,248,461,739)
Net increase in cash and cash equivalents	66,572,904,181	55,579,316	19,213,564,496
Cash and cash equivalents at beginning of year	54,912,699,155	45,844,631	35,699,134,659
Cash and cash equivalents at end of year	W 121,485,603,336	$ 101,423,947	W 54,912,699,155

See accompanying notes to financial statements.

Independent Auditors' Report

Based on a report originally issued in Korean

KPMG Samjong Accounting Corp.

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To the Shareholders and Board of Directors
KT&G Corporation:

We have audited the accompanying balance sheet of KT&G (the "Company" and formerly, Korea Tobacco & Ginseng Corporation) as of December 31, 2003, and the related statements of income, appropriation of retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of the Company's affiliate (Buytheway Co., Ltd). The Company's investment in this affiliate at December 31, 2003 amounted to W23,039 million, and its equity in loss of this affiliate amounted to W1,406 million for the year ended December 31, 2003. The financial statements of this affiliate was audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for this affiliate, is based solely on the reports of other auditors. The financial statements for the year ended December 31, 2002, presented for comparative purposes, were audited by other auditors whose report dated January 23, 2003 expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the Auditing Standards, as established by the Financial Supervisory Commission of 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 and significant estimates used by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of KT&G as of December 31, 2003, and the results of its operations, the changes in its retained earnings, and its cash flows for the year then ended in accordance with the Financial Accounting Standards, as established by the Financial Supervisory Commission of the Republic of Korea.

The accompanying financial statements as of and for the year ended December 31, 2003 have been translated into United States dollars solely for the convenience of the reader and have been translated on the basis set forth in Note 2 to the financial statements.

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

As discussed in Note 2(a) to the financial statements, accounting principles and auditing standards and their application in practice vary among countries. The accompanying financial statements are not intended to present the financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries other than the Republic of Korea. In addition, the procedures and practices utilized in the Republic of Korea to audit such financial statements may differ from those generally accepted and applied in other countries. Accordingly, this report and the accompanying financial statements are for use by those knowledgeable about Korean accounting procedures and auditing standards and their application in practice.

As discussed in Note 2(f) to the financial statements, inventories are stated at the lower of cost or net realizable value. Net realizable value is determined based on the estimated selling price, less estimated completion and selling costs. Loss on valuation of inventories is W 22,676 million and W 12,583 million for the years ended December 31, 2003 and 2002, respectively.

As discussed in Note 28 to the financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of W 407 million caused by smoking. The ultimate effects that these lawsuits and other similar legal actions that may be brought against the Company in future could have on the financial position of the Company cannot presently be determined. Accordingly, no provisions have been made in the accompanying financial statements.

As discussed in Note 29 to the financial statements, the Company has entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund by 2008 with the target amount of W410 billion for the purpose of stabilizing tobacco production. According to the contract, the Company records a provision for the tobacco production stabilization fund based on the target amount. The provision for the fund for the year ended December 31, 2003 amounted to W 19,589 million.

As discussed in Note 10 to the financial statements, the Company makes transactions and maintains balances with related parties. Sales to and expenses to related parties for the year ended December 31, 2003 amounted to W 62,873 million and W 2,974 million, respectively. Also, W 9,014 million and W 1,376 million were due from and due to related parties, respectively, as of December 31, 2003.

As discussed in Note 2(a) to the financial statements, the Company adopted Statements of Korea Accounting Standards No. 2 through No. 9, effective from January 1, 2003. Certain accounts of prior year's financial statements were reclassified to conform to the current year's presentation.

January 30, 2004

KPMG Samjong Accounting Corp.

This report is effective as of January 30, 2004, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying financial statements and notes thereto. Accordingly, the readers of the audit report should understand that there is possibility that the above audit report may have to be revised to reflect the impact of such subsequent event or circumstance, if any

Notes to Financial Statements

(1) Description of the Company and Its Business

KT&G Corporation ("KT&G" or the "Company", formerly Korea Tobacco & Ginseng Corp.) was established on April 1, 1987 as Korea Monopoly Corporation, an entity wholly owned by 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. The Company changed its name once again to KT&G Corporation from Korea Tobacco & Ginseng Corporation, effective December 27, 2002.

The Company is engaged in manufacturing and selling tobacco. As of December 31, 2003, the Company has five manufacturing plants, including the Shin Tan Jin plant, and local headquarters and 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 shareholders approved a plan to separate into two companies by setting up a subsidiary for its red ginseng business segment effective January 1, 1999. The separation was accomplished by the Company's contribution of the assets and liabilities in the red ginseng business segment into a wholly-owned subsidiary, the Korea Ginseng Corp.

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

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

(a) Basis of Presenting Financial Statements -

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

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

The Company adopted statements of Korea Accounting Standard No. 2 through No. 9, effective January 1, 2003. The financial statements for the year ended December 31, 2002 were not restated with the retroactive application of the amended provisions unless otherwise specifically provided for in the standards. However, in accordance with Financial Accounting Standards No. 6, the balance sheet as of December 31, 2002 is before appropriation of retained earnings. These reclassification did not result in any change to reported net earnings or stockholders' equity.

(b) Basis of Translating Financial Statements -

The financial statements are expressed in Korean Won and, solely for the convenience of the reader, have been translated into U.S. dollars at the rate of W1,197.8 to US$1, the basic exchange rate on December 31, 2003. This translation should not be construed as a representation that any or all of the amounts shown could be converted into U.S. dollars at this or any other rate.

(c) Cash Equivalents -

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

(d) Financial Instruments -

Financial instruments include time deposits, installment savings deposits, restricted bank deposits and standardized financial instruments handled by financial institutions.

(e) Allowance for Doubtful Accounts -

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

(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. Accordingly, loss on valuation of inventories recognized amounted to W22,676 million and W12,583 million for the years ended December 31, 2003 and 2002, respectively.

The cost of inventories is determined by the weighted-average method for finished goods, added goods and work-in-process, using the moving-average method for raw materials and supplies, and using the specific identification method for materials-in-transit.

Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method.

(g) Investment in Securities -

Effective from the fiscal year after December 31, 2002, the Company adopted Statement of Korea Accounting Standards (SKAS) No. 8, "Investments in Securities." In accordance with SKAS No, 8, certain debt and equity securities should be classified into one of the three categories of held-to-

Notes to Financial Statements

maturity, available-for-sale, or trading securities at the time of acquisition and such determination should be reassessed at each balance sheet date. Investments in debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) are classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used to generate profit on short-term differences in price. Investments not classified as either held-to-maturity or trading securities are classified as available-for-sale securities.

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

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

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

(h) Investment Securities under the Equity Method of Accounting -

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

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

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

(i) Property, Plant and Equipment -

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

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

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

(j) Intangible Assets -

Intangible assets are stated at cost less accumulated amortization. Amortization is computed using the straight-line method over the expected periods to be benefited, less than 20 years, of the respective assets as follows:

Classification	Expected periods (years)
Industrial property rights	5~10
Water facility use rights	15

(k) Retirement and Severance Benefits -

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

(l) Valuation of Receivables and Payables at Present Value -

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

The difference between nominal value and present value is deducted directly from the nominal value of related receivables or payables and is

Notes to Financial Statements

amortized using the effective interest method. The amount amortized is included in interest expense or interest income.

(m) Foreign Currency Transactions -

Monetary assets and liabilities denominated in foreign currencies are translated into Korea Won at the balance sheet date, with the resulting gains and losses recognized in current results of operations. Monetary assets and liabilities denominated in foreign currencies in the accompanying financial statements are translated at the Base Rates announced by Seoul Money Brokerage Service Ltd., which were W1,197.80 : US$1, W11.1960: JPY ¡ ˝1 and W1,502.58 : EUR€1 at December 31, 2003 and W1,200.40 : US$1 and W1,925.02 : GB¡ 1 at December 31, 2002.

(n) Derivative Instruments -

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

However, for derivative instruments for the purpose of hedging the exposure to the variability of cash flows of a forecasted transaction, the hedge-effective portion of the derivative's gain or loss is deferred as a capital adjustment, a component of stockholder's equity. The ineffective portion of the gain or loss is charged or credited to current results of operations.

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

(o) Revenue Recognition -

Revenue from sales other than on long-term contracts is recognized when a product is shipped, and from rentals as they accrue. 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.

(p) Income Taxes -

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

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

A deferred tax asset is recognized only to the extent that it is probable that future taxable earnings 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,

(q) Dividends Payable -

Effective January 1, 2003, the Company adopted Statement of Korea Accounting Standards No. 6, "Events Occurring After the Balance Sheet Date". Under this standard, dividends are not recorded until approved by the board of directors and shareholders. As a result, the Company adjusted stockholder's equity as of December 1, 2002 by W167,395 million. The amount represents the dividends recorded in 2002 but not yet approved. Under the new standard, for comparative purposes, this amount was retroactively adjusted as of December 31, 2002.

(r) Earnings Per Share -

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

(s) Accounting for Tobacco Excise Taxes and Dues -

The Company records tobacco excise taxes and dues on tobacco as tobacco excise taxes and dues payable upon delivery of its products from manufacturing plants to local branches. Tobacco excise taxes and dues on tobacco stored in local branches are recorded as prepaid tobacco excise taxes and dues. In addition, the Company presents its net sales by deducting tobacco excise taxes and dues on tobacco from gross sales.

(t) Use of Estimates

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

(u) Contingent Liabilities

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

Notes to Financial Statements

(3) Cash and Cash Equivalents

Cash and cash equivalents as of December 31, 2003 and 2002 are summarized as follows :

	Won (Millions)	
Account	2003	2002
Cash on hand	W 3,558	2,899
Passbook accounts	67,928	52,014
Time deposits	10,000	-
Money market fund	20,000	-
Repurchase agreement	20,000	-
Total	W 121,486	54,913

(4) Restricted Deposits

Restricted deposits as of December 31, 2003 and 2002 are as follows :

	Won (Millions)	
Account	2003	2002
Long-term deposits in escrow fund	W 17,137	16,220
Severance benefits insurance deposit	54,288	42,185
Total	W 71,425	58,405

(5) Short- term Financial Instruments

Short-term financial instruments as of December 31, 2003 and 2002 are summarized as follows :

	Won (Millions)					
	Acquisition cost		Fair value		Gain on valuation	
	2003	2002	2003	2002	2003	2002
Hana Bank and other	W 2,057	6,699	2,095	6,737	38	38

(6) Inventories

Inventories as of December 31, 2003 and 2002 are summarized as follows :

		Won (Millions)	
		2003	2002
Finished goods	W	90,441	76,754
Work-in-process		11,164	9,144
Raw materials		1,259,528	1,317,249
Supplies		18,845	13,198
By-products		1,778	1,522
Completed buildings		427	296
Sites for building lotting-out construction		5,026	5,061
Other		11,922	12,224
	W	1,399,131	1,435,448

(7) Other Current Assets

Other current assets as of December 31, 2003 and 2002 are summarized as follows :

		Won (Millions)	
		2003	2002
Short-term loans to employees (note 31)	W	27,663	31,530
Advance payments (note 24)		13,265	21,148
Prepaid tobacco excise taxes and dues (notes 2 and 18)		126,341	149,844
Accrued income		3,195	3,145
Prepaid expenses		882	331
	W	171,346	205,998

(8) Securities

The Company adopted Statement of Accounting Standards ("SAS") No. 8, "Investments in Securities," effective January 1, 2003. Under SAS No. 8, the Company classified beneficiary certificates as trading securities.

Notes to Financial Statements

(a) Trading securities -

Trading securities as of December 31, 2003 and 2002 are summarized as follows :

	Won (Millions)			
	Acquisition cost		Book value (fair value)	
	2003	2002	2003	2002
Beneficiary certificates	W 2,866	53,973	2,893	29,258

(b) Available-for-sale securities -

Available-for-sale securities as of December 31, 2003 and 2002 are summarized as follows:

(i) Equity securities -

Description	Number of shares	Percentage of ownership	Won (Millions)	
			2003	2002
Listed equity securities:				
Yonhap Television News (YTN)	8,380,000	19.95%	W 12,067	11,481
Unlisted equity securities:				
Celltrion. Ltd. (preferred stock)	2,860,000	-	18,866	15,961
Nexgen Biotechnologies, Inc.	100,000	16.18%	2,150	2,150
KT&G USA	100,000	100.00%	584	584
Cosmo Tobacco Co., Ltd. (*)	480,000	40.00%	763	-
Inodis	110,000	19.64%	55	-
Oscotech	230,770	5.18%	2,250	-
Rexhan	500,000	6.56%	2,359	-
Leifenza	10,000	4.90%	1,000	-
			28,027	18,695
Total			W 40,094	30,176

(*) As Cosmo Tobacco Co., Ltd.'s equity in the net book value of its investee has declined significantly and is not expected to recover, W1,777 million of the difference between the book value and the fair value is charged to current results of operations as impairment loss.

(ii) Debt securities

Description	Interest rate per annum (%)	Won (Millions) 2003	2002
Bonds:			
Government bonds and other	5.0 ~ 9.7	W 9,440	9,499
Samsung Corporation	Libor+1.95	95,822	96,030
Woori Finance Holdings Co.	Libor+1.6	88,637	88,830
Gibo Capital Co.	6.55	20,000	20,000
Hyundai Heavy Industries Co.	7.67	50,000	50,000
Hyundai Capital Co.	7.33	39,000	39,000
Crystal Genomics Co.	3.00	999	999
		303,898	304,358
Convertible bonds:			
Yongjin Pharm. Co., Ltd.	9.00	20,153	-
MD Bioalpha	5.50	602	-
		20,755	-
Total		W 324,653	304,358

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

(a) Affiliates' equity securities accounted for using the equity method of accounting for investments as of December 31, 2003 and 2002 are summarized as follows:

Description	Number of shares	Owership percentage	Won (Millions) 2003	2002
Korea Ginseng Co.	32,985,851	100.00%	W 306,983	289,288
Buytheway Co., Ltd.	4,026,201	43.67%	23,039	24,445
Youngin Pharm. Co., Ltd	2,404,714	22.02%	6,700	-
KT&G Turkey	9,900	99.00%	2,203	-
Cosmo Tobacco Co., Ltd. (*)	480,000	40.00%	-	2,540
Total			W 338,925	316,273

Notes to Financial Statements

(*) Cosmo Tobacco Co., Ltd. is excluded from affiliates' equity securities accounted for using the equity method of accounting because its total assets are less than W7 billion.

(b) Investments in affiliates accounted for using the equity method as of December 31, 2003 and 2002 are as follows:

	Won (millions)				
		Adjustment to			
Affiliate	Cost	Retained earnings	Capital adjustment	Income (loss)	Balance at December 31, 2003
Korea Ginseng Co.	W 164,929	74,359	-	67,695	306,983
Buytheway Co., Ltd.	26,314	(1,869)	-	(1,406)	23,039
Youngin Pharm. Co., Ltd	6,700	-	-	-	6,700
KT&G Turkey	2,203	-	-	-	2,203
	W 200,146	72,490	-	66,289	338,925

On January 30, 2003, Korea Ginseng Co. retired W50,000 million of capital stock. The Company purchased equity shares of Youngin Pharm. Co., Ltd. and made equity investment in KT&G Turkey in December 2003, and did not record gain (loss) on valuation of investments using the equity method.

	Won (millions)				
		Adjustment to			
Affiliate	Cost	Retained earnings	Capital adjustment	Income (loss)	Balance at December 31, 2002
Korea Ginseng Co.	W 214,929	38,359	-	36,000	289,288
Buytheway Co., Ltd.	26,314	(2,438)	-	569	24,445
Cosmo Tobacco Co., Ltd.	2,947	-	-	(407)	2,540
	W 244,190	35,921	-	36,162	316,273

(10) Transactions and Balances with Related Companies

Significant transactions and balances with related parties as of and for the years ended December 31, 2003 and 2002 are summarized as follows:

	Won (Millions)	
	2003	2002
Sales and other revenue:		
Buytheway Co., Ltd.	W 62,350	40,358
Korea Ginseng Co.	523	460
	62,873	40,818
Selling and administrative expenses		
Buytheway Co., Ltd.	W561	368
Korea Ginseng Co.	2,413	2,584
	W 2,974	2,952
Due from affiliates:		
Buytheway Co., Ltd.	W 6,559	4,815
Youngin Pharm. Co., Ltd	1,400	-
KT&G USA	817	205
KT&G Turkey	238	-
	W 9,014	5,020
Due to affiliates:		
Korea Ginseng Co	W 1,376	1,604

Notes to Financial Statements

(11) Short-term and Long-term Loans Receivable

Loans receivable as of December 31, 2003 and 2002 are as follows:

Classification	Annual interest rate	Maturity date		Won (millions) 2003	2002
Loan to National Leaf Tobacco					
Growers Cooperative					
Federation in support of leaf					
tobacco cultivation (*)	0.7%(***)	2007.11.20	W	110,000	110,000
Loan to Korea Ginseng					
Cooperative Federation in		2003.12.21 ~			
support of ginseng cultivation	1.5%	2007.12.21		11,200	14,600
Total				121,200	124,600
Present value discount account (**)				(43,322)	(51,992)
Total present value			W	77,878	72,608
Current portion			W	3,400	3,400
Present value discount on current portion				(247)	(247)
			W	3,153	3,153
Long-term loans				117,800	121,200
Present value discount on long-term loans receivable				(43,075)	(51,745)
			W	74,725	69,455

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

(**) The average market interest rates of three-year non-guaranteed corporate bonds at the time of loan origination, 14.01% and 9.7%, were used in calculating the present value of the loans to the National Leaf Tobacco Growers Cooperative Federation and the Korea Ginseng Cooperative Federation, respectively.

(***) The loan to the National Leaf Tobacco Growers Cooperative Federation in support of leaf tobacco cultivation was renewed in 2001 with interest rate decreased from 1.5% to 0.7%. The change in present value discount of W3,334 million resulting from the renewal of the loan has been charged to other bad debts expense for the year ended December 31, 2001.

(12) Property, Plant and Equipment

As of December 31, 2003 and December 31, 2002, property, plant and equipment and related accumulated depreciation are summarized as follows:

	Won (Millions)	
	2003	2002
Land	W 301,909	300,560
Buildings	571,821	461,639
Structures	40,972	35,335
Machinery and equipment	647,170	567,076
Vehicles and other transportation equipment	20,980	16,281
Tools	18,762	14,808
Furniture and fixtures	111,781	81,399
Construction-in-progress	9,806	195,908
Other tangible fixed assets	362	362
	1,723,563	1,673,368
Less accumulated depreciation	(557,889)	(535,711)
	W 1,165,674	1,137,657

W13,956 million of machinery and equipment is expensed in current year because the expected future economic benefit is no longer probable of being realized.

(13) Officially Declared Value of Land

The Company's land, with a book value of W301,226 million, (except for land in the amount of W683 million for which a declared value has not been announced) as of December 31, 2003, has a declared value of W909,878 million as announced by the Korean government for purposes of taxation and governmental land policies.

Notes to Financial Statements

(14) Other Assets

Other assets as of December 31, 2003 and 2002 are summarized as follows:

	Won (Millions)	
	2003	2002
Currency swaps (notes 2 and 29)	W 10,930	6,708
Interest rate swaps (notes 2 and 29)	22,724	8,909
Long-term loans to employees (note 31)	119,624	143,555
Guarantee deposits	21,323	16,566
Deferred income tax assets (notes 2 and 25)	-	11,301
Other	19,857	16,146
	W 194,458	203,185

(15) Convertible Bonds

Convertible bonds as of December 31, 2003 and 2002 and related repayment schedule are as follows:

(a) The 1st overseas convertible bonds

				Won (millions)	
Description	Issue date	Maturity date	Interest rate per annum	2003	2002
The 1st overseas convertible bonds	Oct. 31, 2001	Oct. 31, 2006	2%	W 317,467	317,467
Plus: long-term accrued expenses				18,284	9,610
Less: discount upon issuance				(3,784)	(5,001)
Net				W 331,967	322,076

The 1st foreign convertible bonds denominated in US dollars are convertible into the Company's treasury stock at W20,886 per share, translated using a fixed exchange rate of US$1: W1,300.40, during the period from December 11, 2001 to October 20, 2006 at the option of the bondholders. Interest on such convertible bonds is payable at the end of each 6 month period.

The bonds are to be redeemed on October 31, 2004 at 108.16 percent of their principal amount upon the request of the bondholders or any time from November 15, 2004 at an amount, as agreed at bond issuance, upon advance notice by the Company. For bonds not converted nor redeemed, 114.26 percent of principal will be due in one lump sum on October 31, 2006.

(b) The 1st domestic convertible bonds

Description	Issue date	Maturity date	Interest rate per annum	Won (millions) 2003	2002
The 1st domestic convertible bonds	June 29, 2002	June 29, 2005	3%	W 147,861	492,618
Plus: long-term accrued expenses				9,228	6,714
Less: discount upon issuance				(451)	(1,533)
Net				W 156,638	497,799

For the year ended December 31, 2003, domestic convertible bonds amounting to W344,757 million were converted into 19,346,467 shares of treasury stock

The 1st domestic convertible bonds denominated in Won are convertible into the Company's treasury stock at W17,820 per share, during the period from July 29, 2002 to May 30, 2005 at the option of the bondholders. Interest on such convertible bonds is payable at the end of each 6 month period. For bonds not converted, 108.70 percent of principal will be due in one lump sum on June 29, 2005.

(16) Retirement and Severance Benefits

Changes in the retirement and severance benefits for the years ended December 31, 2003 and 2002 are summarized as follows:

	Won (Millions) 2003	2002
Estimated severance liability at beginning of year	W 69,824	46,981
Provision for retirement and severance benefits	32,766	27,538
Payments	(7,705)	(4,695)
Estimated severance liability at end of year	94,885	69,824
Severance benefits insurance deposit	(54,288)	(42,185)
Net balance at end of year	W 40,597	27,639

(17) Assets and Liabilities Denominated in Foreign Currencies

Details of assets and liabilities denominated in foreign currencies as of December 31, 2003 and 2002 are as follows (in millions of Korean won, thousands of US dollars, thousands of Great Britain pounds, thousands of EUR and thousands of JPY):

Notes to Financial Statements

		Foreign currency			Won equivalent	
		2003	2002		2003	2002
Assets:						
Accounts receivable - trade	USD	35,425	8,021	W	42,432	9,628
Trading securities	¡ ¤	1,996	-		2,391	-
Available-for-sale securities	¡ ¤	153,998	153,998		184,459	184,859
Long-term deposits in escrow fund	¡ ¤	14,307	13,512		17,137	16,220
Cash and cash equivalents	¡ ¤	4,078	3,815		4,884	4,580
Short-term financial instruments	¡ ¤	-	4,000		-	4,801
Notes and accounts receivable - other	¡ ¤	596	-		714	-
Total	USD	210,400	183,346	W	252,017	220,088
Liabilities:						
Accounts payable - trade	USD	4,454	6,585	W	5,335	7,904
Accounts payable - trade	EUR	956	-		1,436	-
Accounts payable - trade	GBP	-	191		-	367
Accounts payable - trade	JPY	412	-		5	-
Accrued interest expense	USD	827	823		991	988
Total	USD	5,281	7,408			
	EUR	956	-			
	GBP	-	191			
	JPY	412	-	W	7,767	9,259

(18) Tobacco Excise Taxes and Dues

Prepaid tobacco excise taxes and dues and tobacco excise taxes and dues payable as of December 31, 2003 and 2002 and tobacco excise taxes and dues for the years ended December 31, 2003 and 2002 are as follows:

	Won (Millions)						
		Prepaid tobacco excise taxes & dues		Tobacco excise taxes & dues payable		Tobacco excise taxes and dues	
		2003	2002	2003	2002	2003	2002
Tobacco excise taxes	W	69,371	82,364	146,092	164,051	1,799,660	1,732,621
Tobacco education taxes		34,685	41,182	73,046	82,026	899,830	866,311
Waste dues		543	641	14,010	13,462	14,107	13,574
Funds for promotion of health		20,383	24,053	42,949	48,109	529,030	422,554
Funds for stabilization of tobacco production		1,359	1,604	2,863	3,207	35,269	32,050
Total	W	126,341	149,844	278,960	310,855	3,277,896	3,067,110

The Company contributes W10 per pack of cigarettes to the Foundation for Stabilization of Tobacco Production until the total amount paid reaches W410,000 million. The cumulative amount contributed to the Foundation as of December 31, 2003 was W76,100 million (W41,700 million in 2003 and W34,400 million in 2002).

(19) Other Current Liabilities

Other current liabilities as of December 31, 2003 and 2002 are summarized as follows:

	Won (Millions)		
		2003	2002
Accrued interest expense	W	1,016	1,137
Accrued expenses		16,422	16,043
Unearned income		652	1,412
	W	18,090	18,592

(20) Common Stock

There were no changes in capital stock for the years ended December 31, 2003 and 2002. Details of capital stock as of December 31, 2003 are as follows (in Korean won):

(a) Authorized shares : 800,000,000 common share

(b) Issued shares : 178,442,497 common share

(c) Common stock par value : W 5,000

Notes to Financial Statements

Stock retirements by charging to retained earnings for the years ended December 31, 2003 and 2002 are summarized as follows:

Date	purchase cost	Number of shares	Issued shares after stock retirement
September 17, 2002	W 168,008 million	9,549,400	181,442,497
November 26, 2003	67,136 million	3,000,000	178,442,497

(21) Treasury Stock

Changes in treasury stock for the year ended December 31, 2003 are summarized as follows:

	Number of shares	Won (Millions)
As of January 1, 2003	61,874,706	W 1,102,638
Change for the year:		
Reissued to employees	(20,180)	(276)
Contributed to the employee's beneficiary fund	(940,000)	(16,461)
Contributed to the non-profit foundation of the Company	(255,000)	(4,466)
Contributed to Employee Stock Ownership Union	(1,301,561)	(22,793)
Reissued to others in stock market	(23,920)	(419)
Exchanged for convertible bonds	(19,346,467)	(313,447)
As of December 31, 2003	39,987,578	W 744,776

Pursuant to the plan to split the Company into two entities by setting up a subsidiary for its red ginseng business segment, after the approval of such plan at the shareholders' meeting on December 28, 1998, the Company reacquired 20,180 shares for W13,656 per share from 33 individuals who dissented from the plan. The Company reissued 20,180 shares to employees on September 17, 2003.

The Company reacquired 8,492,590 shares for W 23,697 per share using its treasury stock fund.

The Company reacquired shares in the stock market during the year ended December 31, 2002. Following such reacquisition of stock at an average purchase price of W 17,512 per share, the Company is holding 10,517,820 shares of treasury stock as of December 31, 2002. The Company contributed 940,000, 255,000 and 1,296,296 shares of treasury stock to the employee's beneficiary fund, KT&G Social Welfare Foundation, and Employee Stock Ownership Union, respectively. In addition, the Company reissued 23,920 shares and 5,265 shares of treasury stock in stock market and executives of the Company. As of December 31, 2003, the Company holds 7,997,339 shares of treasury stock.

The Company plans to reissue a certain number of shares of treasury stock in the future depending upon market condition.

The Company reacquired 15,200,000 shares on October 24, 2001 at an average price of W 17,700 per share in connection with the issuance of the overseas convertible bonds.

The Company reacquired 27,765,630 shares on June 27, 2002 at an average price of W 16,202 per share in connection with the issuance of its domestic convertible bonds. As of December 31, 2003, W 346,923 million of convertible bonds was converted to 19,467,981 shares of common stock. Following such conversion, the Company is holding 8,297,649 shares of treasury stock as of December 31, 2003.

(22) Retained Earnings

Retained earnings as of December 31, 2003 and 2002 comprise the following:

	Won (Millions)	
	2003	2002
Legal reserve	W 602,937	602,937
Reserve for business expansion	698,881	698,881
Reserve for business rationalization	12,851	12,851
Reserve for technology development	36,196	47,816
Reserve for overseas business losses	194	387
Reserve for overseas market development	235	664
Reserve for energy saving facilities	131	266
Other	732,320	722,320
Unappropriated retained earnings at end of year	433,299	205,752
Total	W 2,517,044	2,291,874

(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 Company did not appropriate such reserve for the years ended December 31, 2003 and 2002 as such reserve exceeded 50% of capital stock. The legal reserve may be used to reduce a deficit or it may be transferred to capital stock.

(b) Reserve for Business Rationalization

Under the Special Tax Treatment Control Law, investment tax credit is intermittently 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, however, 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.

Notes to Financial Statements

(c) Reserve for Business Expansion

Under the old Korea Tobacco and Ginseng Corporation Act, the Company is required to appropriate at least 20% of net profit to a reserve for business expansion until such reserve equals 50% of capital stock. The Company did not appropriate such reserve for the years ended December 31, 2003 and 2002 as such reserve exceeded 50% of capital stock. This reserve may be used to reduce a future deficit or it may be transferred to capital stock.

(d) Other Reserves

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

(23) Dividends

Details of dividends for the years ended December 31, 2003 and 2002 are as follows:

	Won (Millions)	
	2003	2002
Cash dividends	W 221,528	167,395
Net earnings	459,701	347,444
Dividends as a percentage of net earnings	48.19%	48.18%

(24) Building Lotting-out Construction Contract

(a) Details of building lotting-out construction work for the year ended December 31, 2003 are summarized as follows:

	Won (Millions)			
Item	Balance at Jan. 1, '03	Change in amount	Revenue recognized	Balance as of December 31, '03
Multi-purpose buildings in Dongdaemoon area	W 96,736	53,076	(16,270)	133,542

(b) Details of installment sales as of December 31, 2003 are summarized as follows:

	Won (Millions)				
Item	Expected total contract price	Confirmed contract price	Cumulative collections	Advances	Uncollected
Multi-purpose buildings in Dongdaemoon area	W 161,401	149,812	52,450	36,798	617

(c) Guarantees

As of December 31, 2003 guarantees provided by other companies relating to construction are as follows:

Guarantor	Builder	Type of guarantee	Description	Guaranteed amount (Won (Millions))
Seoul Guarantee Insurance	SsangYong Engineering & Construction Co., Ltd.	Construction performance	Multi-purpose buildings in Dongdaemoon area	W 12,918

(d) Cost of Sales

Cost of installment sales of store units for the years ended December 31, 2003 and 2002 are as follows:

	Won (Millions)	
Account	2003	2002
Land	W 481	82
Outsourcing cost	4,038	1,034
Total cost of buildings for the year	4,519	1,116
Completed buildings:		
Beginning of the year	296	-
End of the year	(427)	(296)
Cost of sales of buildings	W 4,388	820

(25) Income Taxes

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

Notes to Financial Statements

Taxable earnings	Prior to 2005	Thereafter
Up to W100 million	16.5%	14.3%
Over W100million	29.7%	27.5%

On December 9, 2003, the Korea government reduced the corporate income tax rate beginning in 2005. Specifically, effective from January 1, 2005, the income tax rate will be reduced from 29.7% to 27.5%. As a result, a change in deferred income taxes of W1,162 million is charged to current income tax expense for the year ended December 31, 2003.

(b) The components of income tax expense for the years ended December 31, 2003 and 2002 are summarized as follows:

	Won (Millions)	
	2003	2002
Current tax	W 161,344	154,735
Deferred tax	22,912	(8,578)
	W 184,256	146,157

(25) Income Taxes, Continued

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

	Won (Millions)
Provision for income taxes at normal tax rate	W 192,592
Tax effects of permanent differences, primarily entertainment expenses in excess of tax limit	38,247
Items directly recognized in equity	(33,796)
Tax credit	(13,936)
The tax effect of change in beginning balance of temporary differences	2,311
The tax effect of change in income tax rate	(1,162)
Actual provision for income taxes	W 184,256

The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 28.61% and 29.61% for the years ended December 31, 2003 and 2002, respectively.

(d) The tax effects of temporary differences that result in significant portions of the deferred income tax assets and liabilities as of December 31, 2003 and 2002 are presented below:

	Won (Millions)		
		2003	2002
Deductible temporary differences:			
Allowance for severance and retirement benefits	W	55,894	42,159
Loss on valuation of inventories		22,676	12,583
Depreciation		9,314	8,982
Construction-in-progress		775	754
Gain on prior period error correction (depreciation)		7	7
Loss on disposal of property and equipment		202	198
Bad debts		17,424	14,803
Loss on valuation of marketable securities		-	25,594
Long-term accrued interest expense		27,512	16,325
Value added tax		10	9
Present value discounts		43,322	51,993
Available-for-sale securities impairment loss		1,777	-
Provision for Tobacco Production Stabilization Fund		19,589	-
Other bad debts		13,686	13,948
Loss on foreign currency translation		-	3
Cost of sales of buildings		-	820
Total	W	212,188	188,178

Notes to Financial Statements

	Won (Millions) 2003	2002
Taxable temporary differences:		
Accrued income	W 3,195	3,097
Additional acquisition tax	195	195
Deposits for severance and retirement benefits	54,288	41,497
Debenture issuance costs	186	133
Gain on valuation of marketable securities	26	119
Reserve for technological development	43,307	36,196
Reserve for export losses	-	194
Reserve for overseas market exploration	-	235
Reserve for energy saving facilities	-	134
Gain on valuation of short-term financial instruments	-	38
Investments using the equity method of accounting	123,037	56,748
Gain on valuation of investment securities	6,379	6,379
Currency swaps	1,308	1,954
Interest rate swaps	23,275	8,759
Sales of buildings	-	2,230
Total	W 255,196	157,908

Tax effect of temporary differences :		
Deferred income tax assets	W 59,445	55,889
Deferred income tax liabilities	(71,056)	(46,899)
Deferred income tax asset (liability), net	W (11,611)	8,990

(26) Earnings Per Share

Earnings per share for the years ended December 31, 2003 and 2002 are as follows:

(a) Basic earnings per share

		Won (Millions)	
		2003	2002
Net income per accompanying			
statement of income	W	459,700,817,035	347,444,073,870
Weighted-average number of common shares outstanding		123,427,573	146,988,542
Earnings per share	W	3,724	2,364

(b) Diluted earnings per share

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

		2003	2002
Net income per accompanying statement of income	W	459,700,817,035	347,444,073,870
Add: interest on convertible bonds, net of tax		26,214,092,269	20,596,437,464
Diluted net income (A)		485,914,909,304	368,040,511,334
Weighted-average number of outstanding shares (B)		146,925,222	176,578,630
Diluted net earnings per share (A/B)	W	3,307	2,084

(27) Insurance

Buildings, structures, machinery and inventories were insured against fire damage up to W 793,638 million as of December 31, 2003 by DonBu Fire & Marine Insurance. In addition, the Company carries comprehensive automobile insurance on its vehicles, unemployment insurance and workers' accident compensation insurance.

(28) Pending Litigation

A tobacco lawsuit claiming damages of W100 million was filed against the Company and the Korean government for the first time in Korean history in September 1999. In addition, a legal action seeking another W307 million in damages was taken by a group of 30 people alleging smoking related diseases in January 2000. Plaintiffs assert that the Company and the Korean government did not perform their obligation to notify smokers of the health hazards influence of smoking. The lawsuits are currently pending as of December 31, 2003 and the outcome of the litigation cannot be reasonably estimated.

There are six additional lawsuits against the Company involving approximately W1,668 million. The amount of any liability the Company may

Notes to Financial Statements

ultimately have with respect to the litigation cannot be reasonably estimated as of December 31, 2003.

(29) Commitments and Contingencies

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

Additionally, the Company has entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund by 2008 with the target amount of W410 billion for the purpose of stabilizing tobacco production. According to the contract, the Company records provision for the tobacco production stabilization fund based on the target amount. The provision for the fund for the year ended December 31, 2003 amounted to W19,589 million.

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

(c) Currency and interest rate swaps

Details of currency swap and interest rate swap contracts of the Company as of December 31, 2003 are as follows:

1) In November 2001 the Company had three currency swap and two interest rate swap contracts to match cash outflows from convertible bonds with cash inflows from investments in bonds, which were purchased using the proceeds from convertible bond issuance. Valuation gains or losses on such swap contracts are included in current operations.

2) Currency swap contracts (in millions of Korean won and thousands of US dollars)

Counterpart	Period	Contract amount		Contracted exchange rate	
		To pay	To receive	To pay	To receive
Industrial Bank of Korea	2001.11~2004.10	W 20,000	$ 15,576	6.39%	2%(*)
The Korea Development Bank	2001.11~2004.10	39,000	30,709	6.34%	2%(**)
The Korea Development Bank	2002.11~2004.10	50,000	38,941	6.31%	2%(***)

(*) IBK is to pay the Company US$ 1,271,028 (8.16% of notional amount) on October 29, 2004.

(**) KDB is to pay the Company US$ 2,505,827 (8.16% of notional amount) on October 29, 2004.

(***) KDB is to pay the Company US$ 3,177,570 (8.16% of notional amount) on October 29, 2004.

3) Interest swap contracts (in thousands of US dollars)

Counterpart	Period	Notional amount	Contracted exchange rate: To pay	Contracted exchange rate: To receive
UBS Warburg	2001.11~2004.11	$ 74,000	6M Libor+1.6%	2.91%(*)
Credit Suisse First Boston	2001.11~2004.10	$ 80,000	6M Libor+1.95%	3.96%(**)

(*) UBS is to pay the Company US$ 6,038,400 (8.16% of notional amount) on October 29, 2004.

(**) CSFB is to pay the Company US$ 6,528,000 (8.16% of notional amount) on October 29, 2004.

4) Details of valuation of derivative instruments at December 31, 2003 are as follows:

Type	Won (Millions): Valuation gain (loss) (B/S)	Credited (charged) to current operations	Capital adjustment
Currency swaps	W 10,930	(646)	-
Interest rate swaps	22,724	14,516	-
Total	W 33,654	13,870	-

(30) Added Value

The components of manufacturing costs and selling and general administrative expenses which are necessary in calculating added value for the years ended December 31, 2003 and 2002 are as follows :

	Won (Millions)					
	Manufacturing cost		Selling general and administrative expenses		Total	
	2003	2002	2003	2002	2003	2002
Wages and salaries	W 120,663	122,111	151,718	141,168	272,381	263,279
Provision for severance benefits	10,800	9,475	17,580	12,853	28,380	22,328
Employee welfare	24,243	11,625	31,259	12,934	55,502	24,559
Rent	85	83	2,370	1,311	2,455	1,394
Depreciation	54,787	51,122	32,657	28,584	87,444	79,706
Taxes and dues	2,442	3,682	9,461	8,363	11,903	12,045

Notes to Financial Statements

(31) Employee Welfare and Contributions to Society

The Company has provided loans to directors and employees for the purchase or lease of houses up to W20 million per person. As of December 31, 2003 and December 31, 2002, the Company has loans receivable of W147,286 million and W175,085 million, respectively, including loans extended for the purchase of the Company's stock, purchase or lease of houses and other purposes. Additionally, for employee welfare, the Company maintains a refectory, an infirmary, a scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spending for the years ended December 31, 2003 and 2002 were W 55,502 million and W24,559 million, respectively.

The Company donated W 42,710 million to KT&G Social Welfare Foundation and others for the year ended December 31, 2003.

(32) Profit Sharing Plan

The Company adopted an Employee Stock Ownership Plan ("ESOP"), effective from June 6, 2003. Under the ESOP, on December 31, 2003, the Company distributed 1,296,296 shares of its treasury stock to the employees through the Employee Stock Ownership Union and 5,265 shares to managerial officers, and the Company bestowed W3,973 million in kind, with the total amounting to W31,892 million in employee welfare spending for 2003.

(33) Planned acquisition

The Company's board of directors has approved the Company's plan to invest W14,600 million in Yungjin Pharm. Co., Ltd., which is currently under the court receivership. The planned investment will be made in 2004. The amount to be invested will be contingent upon the result of future discussions with Yungjin Pharm. Co., Ltd.

(34) Selling and Administrative Expenses

The details of selling and administrative expenses for the years ended December 31, 2003 and 2002 are as follows:

	Won (Millions)	
	2003	2002
Salaries	W 151,718	141,168
Provision for severance benefits	17,580	12,853
Welfare	31,259	12,934
Travel	4,721	5,419
Communications	3,390	3,217
Water, light and heating	2,870	2,610
Taxes and dues	9,461	8,363
Supplies	2,212	2,743
Clothing	1,141	879
Rent	2,370	1,311
Depreciation	32,150	28,145
Amortization	506	439
Repairs and maintenance	3,003	2,341
Vehicles	3,993	2,934
Insurance	395	424
Commissions	36,681	30,556
Transportation and warehousing	23,318	18,272
Entertainment	465	313
Conventions	1,331	1,209
Advertising	135,145	76,113
Training	5,926	7,448
Prizes and rewards	1,616	1,064
Cooperation	168	256
Normal research and development	20,364	10,344
Samples	3,061	2,299
Bad debts	357	678
Miscellaneous	711	591
Total	W 495,912	374,923

Notes to Financial Statements

(35) Economic Environment

In common with other Asian countries, the economic environment in the Republic of Korea continues to be volatile. In addition, the Korean government and the private sector continue to implement structural reforms to historical business practices including corporate governance. The Company may be either directly or indirectly affected by these economic conditions and the reform program described above. The accompanying financial statements reflect management's assessment of the impact to date of the economic environment on the financial position and results of operations of the Company. Actual results may differ materially from management's current assessment.

Board of Directors

Young-kyoon Kwak
Chairman & CEO

Kwang-youl Lee
Senior Managing Director of Overseas Business Headquarters

Young-jin Min
Senior Managing Director of Marketing & Sales Headquarters

Ki-ho Kim
Outside Director

Byong-kyun Kim
Outside Director

Jin-hyun Kim
Outside Director

Choong-sup Kim
Outside Director

Soon-moo Soh
Outside Director

Suck-kyo Ahn
Outside Director

Yeon-cheon Oh
Outside Director

Kyung-jae Lee
Outside Director

Man-woo Lee
Outside Director

Sun-gak Cha
Outside Director

Organization Chart

- General Meeting of Shareholders
- Chairman & CEO
- Board of Directors
  - Executive Committee
  - Evaluation, Compensation & Risk Management Committee
  - Audit Committee
  - Public Interest & Transparency Management Committee
  - Nomination Committee for Outside Director Candidates
  - Nomination Committee for CEO Candidates

Chairman & CEO

- Planning & Coordination Office
- Public Relations Office
- Technology Development Office
- Management Information Office
- Auditing Office
- Secretary Office

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

- Manufacturing Headquarters
  - Manufacturing Bureau
  - Quality Management Bureau
- Leaf Tobacco & Procurement Headquarters
  - Leaf Tobacco Bureau
  - Procurement Bureau
- Business Development Headquarters
  - New Business Development Bureau
- Real Estate Development Headquarters
  - Real Estate Business Bureau
  - Asset Management Bureau

Manufacturing and Sales Network

Leaf Tobacco Processing

- Kimchon factory
- Namwon factory

Tobacco Manufacturing

- Shintanjin plant
- Wonju plant
- Kwangju plant
- Chongju plant
- Yeongju plant

Printing Plant

- Chonan plant

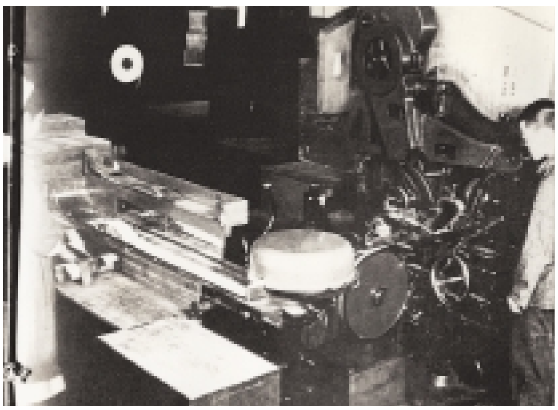
Sales

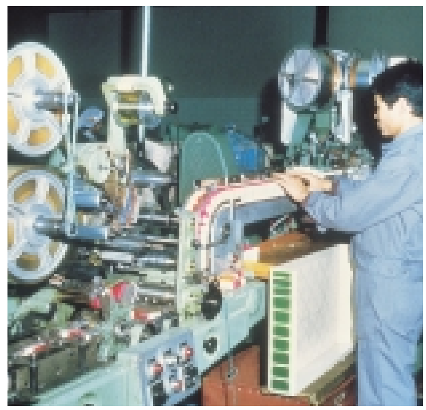
- Regional Headquarters : 12
- Branch Offices : 144

Product History

The history of KT&G is inseparable from the history of modern Korea itself. Down the years, our signature brands have embodied each of the many stages in the nation's development. From liberation and independence to economic development and the Seoul Olympic Games, KT&G has always been a name to trust.

Having achieved an historic performance in 2003, our first year as a privatized company, we are looking now to a future of continued success. As we build KT&G into a global brand, we are confident of emerging among the world's top-five tobacco companies and developing our ginseng business into an internationally renowned name.





1960s-1970s

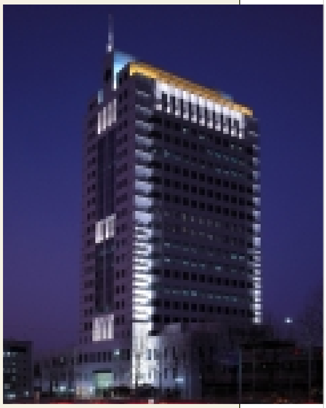
In two decades of unprecedented industrial and economic growth, KT&G's brands such as Sunflower and New Nation epitomized the country's determination to build a prosperous future.

1940s-1950s

KT&G's brands were a part of the backdrop at the birth of modern Korea as the nation celebrated liberation and the establishment of an independent government.

2000s

In the 21st century, the refined taste and modern appeal of KT&G's premium brands such as Raison and THE ONE are satisfying a new generation of customers.



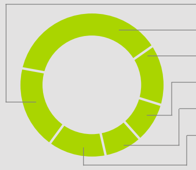
1980-1990s

As Korea welcomed the world to the 1988 Seoul Olympic Games, KT&G's brands such as Eighty-Eight and This reflected the growing confidence and optimism of the nation.

Investor Information

Capital Stock	KRW955 billion
Number of Authorized Shares	800,000,000
Number of Outstanding Common Shares	138,454,919
Stockholders' Equity	KRW2,152 billion
Number of Employees	4,564

Ownership Structure (%)



Treasury Stocks	22.4%
Foreign investors	38.0%
Industrial Bank of Korea	10.8%
Daehan Investment Trust Securities	7.4%
Employees	6.8%
Others	14.6%

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KT&G

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