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Feel Moment, Fill Life KT&G

KT&G 2012 Annual Report

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Feel Moment, Fill Life

KT&G

Contents

KT&G is committed to being open, honest, transparent, forward-looking, and creative. Sharing and caring are part of our DNA. Our vision, corporate image, brand, and management system reflect our ultimate goal of creating happier lives for our customers, shareholders, employees, and the communities we work in.

KT&G: Honest and transparent

KT&G places the interests of its shareholders first and foremost. This includes a commitment to open and transparent management, and a corporate governance model that enhances shareholder value and earns the trust and respect of all its stakeholders. The autonomy and creativity of our employees and the development and maintenance of a future-oriented, responsible management system are two of our greatest priorities.

KT&G: Forward-looking and creative

KT&G is committed to overseas expansion, qualitative growth based on a high-value-added product portfolio, and creating demands and values that change the very rules that define the marketplace. Our innovative management activities continue to strengthen our competitiveness in an increasingly aggressive global market. We believe that change and innovation are the best means of building a forward-looking and creative corporate culture.

KT&G: Sharing and Caring

KT&G's employee-led corporate social responsibilities activities include the Sangsang Fund, Sangsang Together, Sangsang Volunteers, and the Good Feedback Campaign. In our role as a caring and sharing company that grows together with its customers, shareholders, employees, and the communities in which it operates, we are creating new values in a broad range of areas, including assisting the underprivileged, culture and the arts, social assistance facilities, and scholarships. Our goals are to contribute to the public good and to become a sustainable and socially responsible company.

Financial Highlights

Operational Results

	2008	2009	2010	2011	2012
Net Sales	2,573	2,776	2,500	2,491	**2,638**
Operating Profit	1,046	947	925	898	**973**
Net Profit	850	745	931	776	**768**
Total Assets	4,614	4,788	5,254	5,418	**5,918**
Total Liabilities	1,159	935	916	874	**1,015**
Total Shareholders' Equity	3,454	3,853	4,338	4,544	**4,903**

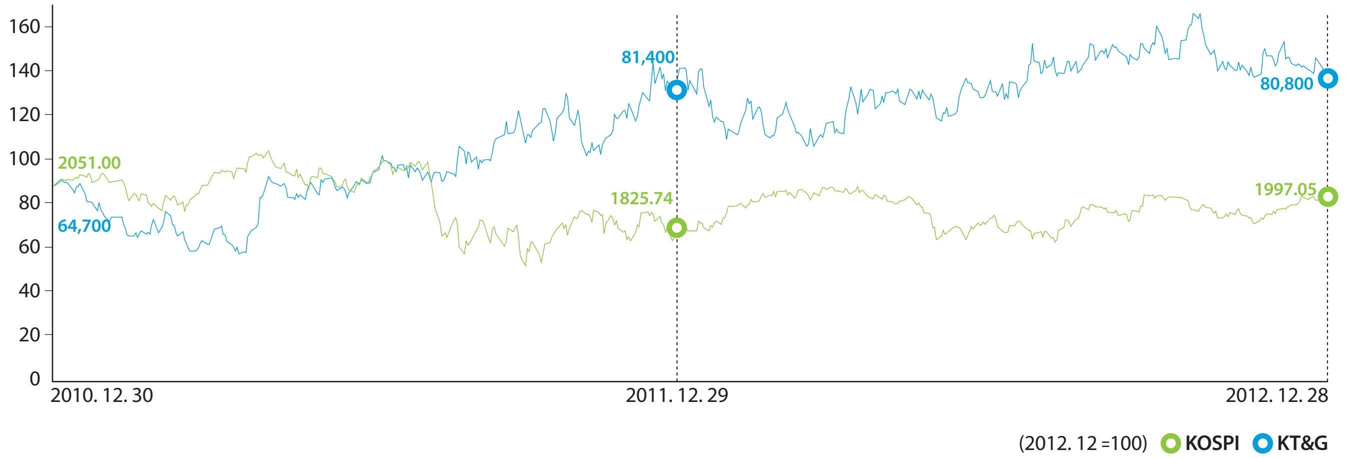
(in billions of KRW)

Financial Results

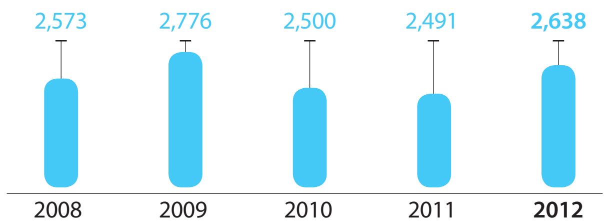
	2008	2009	2010	2011	2012
ROA	19.8	15.8	17.7	14.3	**13.0**
ROE	25.8	20.4	21.5	17.1	**15.7**
Operating Profit Margin	40.7	34.1	37.0	36.0	**36.9**
Net Profit Margin	33.0	26.8	37.2	31.2	**29.1**
EPS(KRW)	6,527	5,803	7,317	6,134	**6,111**
Payout Ratio	40.3	47.8	41.0	52.2	**52.4**
DPS	2,800	2,800	3,000	3,200	**3,200**
Liabilities-to-equity Ratio	33.6	24.3	21.1	19.2	**20.7**
Net debt-to-equity Ratio	-	-	-	-	**-**

(%, KRW)

Stock Price

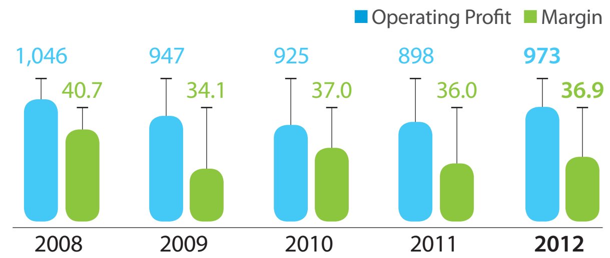


Net Sales



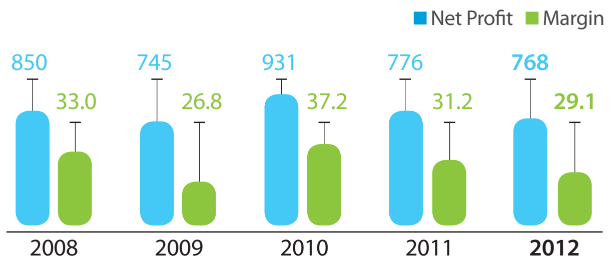
(in billions of KRW)

Operating Profit & Margin



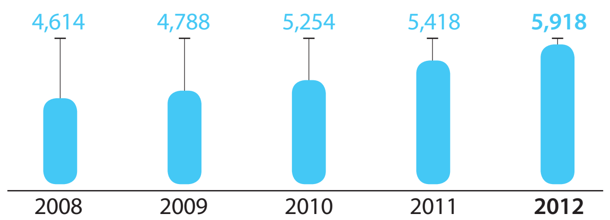
(in billions of KRW, %)

Net Profit & Margin



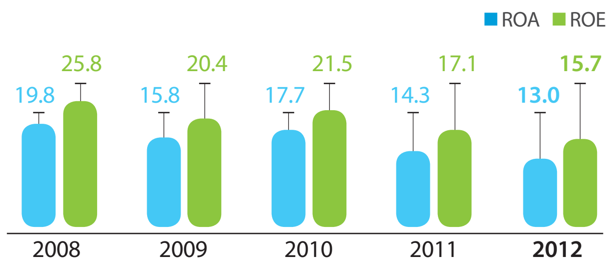
(in billions of KRW, %)

Total Assets



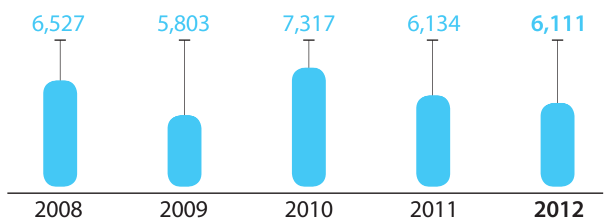
(in billions of KRW)

ROA & ROE



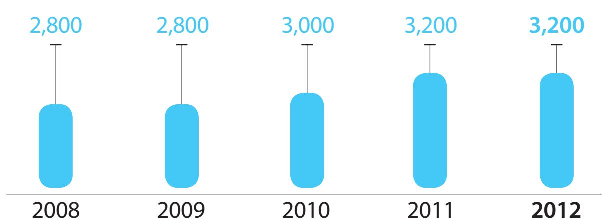
(%)

EPS



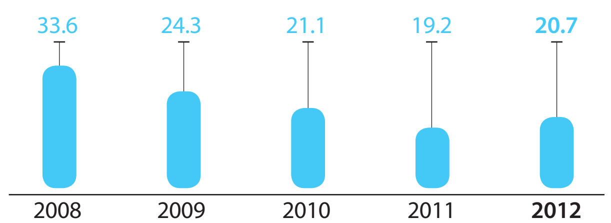
(KRW)

DPS



(KRW)

Liabilities-to-equity Ratio



(%)

CEO's Message

Dear valued shareholders:

First of all, I would like to thank you for your continuing interest in and support of KT&G.

In 2012, everyone at KT&G worked hard to help bring our vision of growing into a high-net-worth global company to reality. We did this even in the face of the continuing sovereign debt crisis in the Euro zone, a weak Korean economy, and intensifying market competition.

We are dedicated to innovating how we work, strengthening ur communications abilities, and pursuing forward-looking management that ensures our sustained and sustainable growth. In 2012, this included reorganizing our personnel system and evamping our organizational infrastructure to strengthen the fundamentals of a high-performance organization.

We raised our share of the tobacco market in Korea by three percent. This was done by launching differentiated new brands and responding proactively to the demands of the marketplace in a very competitive operating environment. In terms of our overseas tobacco business, we came closer to our goal of being a member of the "global big four" by tapping into new markets in an aggressive and persistent manner. This helped us to offset stagnant growth in our key markets.

Although our red ginseng business experienced slower growth due to the depressed domestic economy, we took steps to prepare ourselves for the future by improving our organizational capabilities. We also pursued a number of new growth engine businesses that will add to our future shareholder value and enhance the Group's potential for growth and profitability.

KT&G Life Science won approval for its new atopy medicine from the Korea Food & Drug Administration. In addition, Somang Cosmetics added to its brand competitiveness by completely reorganizing its brand portfolio. Our other subsidiaries, like KGC Life & Gin, Jilin Hanzheng Ginseng, Trisakti, and KGC Yebon also laid the groundwork to carry out their operations more systematically. Thanks to all the efforts mentioned above, KT&G posted sales of KRW2,637.6 billion, operating profit of KRW972.7 billion, and net profit of KRW768.4 billion.

Many experts believe that the world economy will begin to show a modest recovery in 2013, gradually emerging from the shocks of the global financial crisis that began in 2008. Despite this, the problems in the Euro zone have yet to be completely resolved, while other uncertainties in our management environment will likely continue, including increasing volatility in terms of both exchange and interest rates following a process of quantitative easing by more advanced nations. In addition, our business conditions do not show any sign of improving. These factors include an ongoing decline in demand for tobacco, increased taxes on tobacco products, and more and more regulations governing our activities.

Despite these many negative factors, KT&G has a long history of never giving up. We will continue in this vein by committing ourselves anew to change and innovation.

The first thing that we will do is strengthen our existing businesses by increasing their competitiveness and expanding our overseas market operations. In addition, we will turn our flagship products, such as tobacco, red ginseng, and pharmaceuticals, into truly global brands. These steps will help us to overcome slowing growth in the domestic market. We will also focus on building our portfolio of high-value products. This will facilitate our qualitative growth and allow us to gain an early edge on our competitors by meeting the constantly changing needs of our customers and creating new demand and value.

The second step that we will take is to create and foster the development of new growth engines, such as our health-related businesses. We will do this by adding to their brand attractiveness, increasing the value of their signature brands, and expanding their distribution networks. We will also clarify the roles of each of our affiliated companies and maximize synergy effects among them by making the best use of each one's core abilities.

Thirdly, we will pursue a financial strategy that balances maximizing shareholder value and making continuing investments in our growth. This will include sharing our management results with our shareholders and exploring promising investment opportunities from a long-term growth perspective.

Finally, we will continue with the development of a progressive and creative organizational culture.

If we continue with our strategy of focusing on change and innovation from a mid- to long-term perspective, we will transform KT&G into a strong and healthy organization that does not fear failure and thrives on challenges. KT&G will challenge the world through its commitment to principled and forward-looking management. As always, our primary goal is to improve shareholder value through steady growth and the generation of high earnings.

Thank you.

Min, Young-Jin President & CEO

2012 News

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01. Launched a wide variety of new products and enjoyed rising market share

KT&G introduced a wide variety of new products in 2012. They included the ESSE SENSE bestselling super-slim cigarette brand; ESSE ICE 1mg; BOHEM CIGAR CUBANA DOUBLE; RAISON AERO; RAISON PRESSO; and CLOUD9 Slims. The company's market share rose by 3% over the year to reach 62%.

02. Opened KT&G Life Sciences Corp. for development of new medicines

KT&G opened its KT&G Life Sciences Corp. in its Seoul office last March. Renamed KT&G Life Sciences, it has boosted the company's R&D capacities dramatically by adding to its stable of experts in the field of developing new medicines. Plans call for it to grow into a company that will specialize in the development of innovative new medicines in a wide range of areas. It is currently working on the commercialization of an atopy treatment and the development of new drugs for metabolic disorders.

03. Launched Tonino Lamborghini cigarette brand

KT&G led the global cigarette industry by launching "Tonino Lamborghini," an exciting new product that it developed in collaboration with the Italian luxury brand Tonino Lamborghini. The cigarette, which gives smokers a full, rich, and super-smooth feeling in their throats, is made with high-end "Smoking Leaf" and "Orient Leaf" tobaccos. It is also the first Korean cigarette product to use such high-quality materials as moisture-retaining double-OPP film and an embossed Leaf Release Filter. KT&G plans to grow it into a global luxury brand by selling it in a wide range of overseas markets, based on its exclusive worldwide sales rights.

04. Signed MOU to develop Sangsang Madang in Chuncheon

KT&G signed an MOU with the province of Gangwon-do and the city of Chuncheon to develop the Chuncheon Sangsang Madang. The signing took place in July 2012. To be developed as a cultural and arts complex, it will feature concerts, exhibitions, and cultural and arts training programs. It is scheduled to open during the first half of 2014.

05. Included in DJSI World for third consecutive year

KT&G was included in the Dow Jones Sustainability World Index for the third straight year, winning particular recognition for its world-class sustainable management activities. The Index is used to evaluate the performance of the world's leading companies according to a broad set of economic, environmental and social criteria. According to data released by the Korea Productivity Center in September 2012, only 340 of the 2,522 targeted companies were included in the DJSI World Indexes. Nineteen of them were from Korea, including KT&G.

06. Named excellent company for social responsibility management

KT&G was named an excellent company for social responsibility management at the 2012 Symbiotic Social Responsibility Management Conference held in September 2012, co-sponsored by the Korea JoongAng Daily and the Ministry of Knowledge Economy. Thirty-two companies and organizations were selected in the area of social responsibility management following an evaluation of their sustainability management strategies, activities, and performances. Since a business' social role is fast becoming just as important as its plans for expansion in ensuring its sustainable growth, its social responsibility activities are now becoming an integral part of its management activities. KT&G's selection recognized that the company has been fulfilling all of its responsibilities as an exemplary corporate citizen.

07. Began sale of apartments in collaboration with GS Engineering & Construction

KT&G is carrying forward an apartment construction project in the district of Dangbuk-dong, Andong city, in cooperation with GS Engineering & Construction. The project will include the construction of 952 apartments in eleven buildings. Developed by KT&G and being constructed by GS E&G, the apartments were put on sale under the Xi brand in November 2012.

Excellence through value creation

Global Player KT&G: Making everyone's lives happier

Vision and Strategies

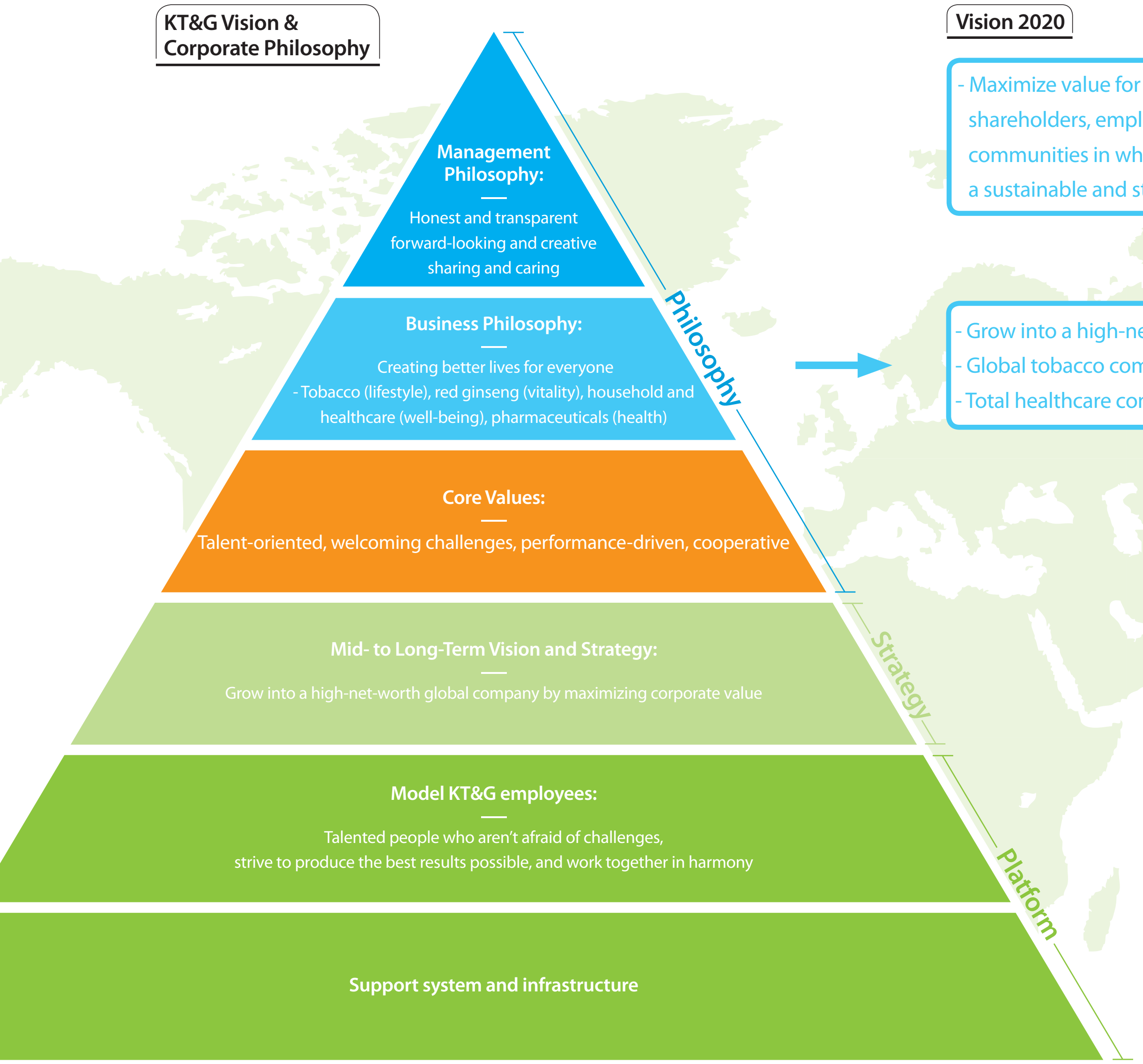
KT&G: Making life happier through value creation

KT&G's business vision, corporate image, brand, and management system are all centered on the value structure of its Group. It is committed to helping its customers, shareholders, employees, and the communities in which it operates enjoy better and more fruitful lives.

Growing into a high net-worth company

Our ultimate goal is to create happier lives by maximizing value for all our stakeholders, including our customers, shareholders, employees, and the communities in which we operate. In order to realize this goal, we have centered our management philosophy, operating principles, and corporate vision on the value structure of our Group, offering our customers products and services that they know they can trust and enjoy. Our overall goal is to grow into a company that combines stability with a strong potential for growth. We will do this by building a balanced business structure consisting of tobacco products, health functional foods, and pharmaceuticals.

KT&G Vision & Corporate Philosophy



Vision 2020

- Maximize value for our customers, shareholders, employees, and the communities in which we operate by being a sustainable and stable business

- Grow into a high-net-worth global company
- Global tobacco company
- Total healthcare company

Corporate Vision 2020

KT&G will bring its vision of being a high-net-worth company with a healthy and balanced business portfolio to fruition by growing into a total healthcare company and one of the four leading tobacco companies in the world.

One of the four leading tobacco companies in the world
- Grow through overseas expansion and by participating in strategic alliances

A total health care company (products + services)
- World's leading red ginseng company
- One of Korea's leading producers of health functional foods
- One of Korea's top three herbal and ginseng cosmetics companies
- One of Korea's top-ten bio/pharmaceutical companies
- A pioneer in the area of health-oriented services

EVER-KT&G 2015: Enhancing our reputation as a model of sustainable management

KT&G added to its reputation as a model of sustainable management in 2012 by undertaking a number of innovative business activities. They included a strengthened environmental management regimen, overseas market expansion, new business developments, and launching a wide launge of new products.

Sustainable management vision

We have named our sustainable management goal "EVER-KT&G 2015." The first "E" stands for excellent economic performances. The "V" is for economic, environmental, and social value creation, while the second "E" means being an eco-friendly company and the "R" is for a being a business that fulfills all its social responsibilities. This reflects our commitment to achieving our sustainable management results in terms of environmental, social, and economic values by 2015. The KT&G post-2015 vision and strategy for sustainable management will be drawn up in the near future.

E Excellent (economic performances)
Create economic values through globalization and by diversifying into new businesses

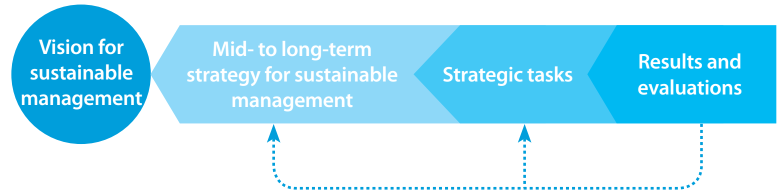
V Value Creating (value creation)
Create added economic, environmental, and social values

E Eco-Friendly (environment)
Create environmental values through eco-friendly management

R Responsible (society)
Create social values through responsible management activities

Application of Sustainable Management Strategies and Feedback Process

We have established a number of sustainable management strategies in the economic, social, and environmental areas, including the development of company-wide and department-specific action plans. Our goal is to establish sustainable management as an irreplaceable part of our corporate culture. This will be done by encouraging cooperation and collaboration, insisting on results-oriented management, and carrying out constant evaluations.



Vision and Strategies

Sustainable Management Vision and Strategy System

Vision - Grow into a high-net-worth global company by creating new value

Mission - EVER-KT&G 2015

	Economy	Society	Environment
Strategic Directions	Enhance competitiveness through value-oriented changes	Promote win-win partnerships by fulfilling our role as a caring and concerned corporate citizen	Build a green company through eco-friendly businesses
Strategic Tasks	· Strengthen competitiveness of core businesses · Increase number of innovation leadership activities · Add to corporate value through diversification	· Maximize customer value · Maximize human resources value · Strengthen win-win partnerships	· Reinforce eco-friendly management system · Strengthen ability to respond to environmental risks · Build eco-friendly corporate culture
Priorities	· Gain early edge in overseas markets · Strengthen foundations for sustainable management · Build sustainable management network both at home and abroad · Connect with mid-to long-term master plans · Train globally-oriented leaders and experts · Maintain value-oriented business portfolio · Promote new businesses	· Enhance customer satisfaction · Add to number of employee benefits · Strengthen linkage between performance and compensation · Manage network of stakeholders more efficiently · Develop sustainable supply chain · Increase number of social contributions activities · Establish business philosophy · Obey all industry-based rules and regulations	· Reinforce environmental management organization · Develop environmental management programs · Carry out training in environmental issues · Boost environmental friendliness of products · Increase amount of green purchasing · Bolster climate change response system · Increase amount of external nvironmental communications

KT&G: Imagining a better tomorrow

KT&G's core values include being customer-centered, performance-driven, and talent-oriented. We prize human resources who welcome challenges and work together well to ensure our growth and prosperity. Our goal is to help people enjoy happier tomorrows. We will maximize our growth potential, profitability, stability, and sustainability by building a balanced business structure that includes our tobacco, red ginseng, household and healthcare, and bio and pharmaceutical businesses.

A well-respected company that is always trusted by its customers

Our top priority is to win customer trust and respect through responsible and ethical management. We want to be known as a company that is honest and transparent, forward-looking and creative, and sharing and caring.

Human Resources Management

Strengthening our corporate value requires the services of a host of creative and multi-talented human resources who are not afraid to take on challenges, as well as the development of a people-centered management system that supports their growth and enhances their job satisfaction. We are committed to maximizing our performances through the creation of a responsive and responsible management organization that prioritizes human resources who can communicate and work well together and provide leadership in terms of both change and innovation.

Human Resources Management

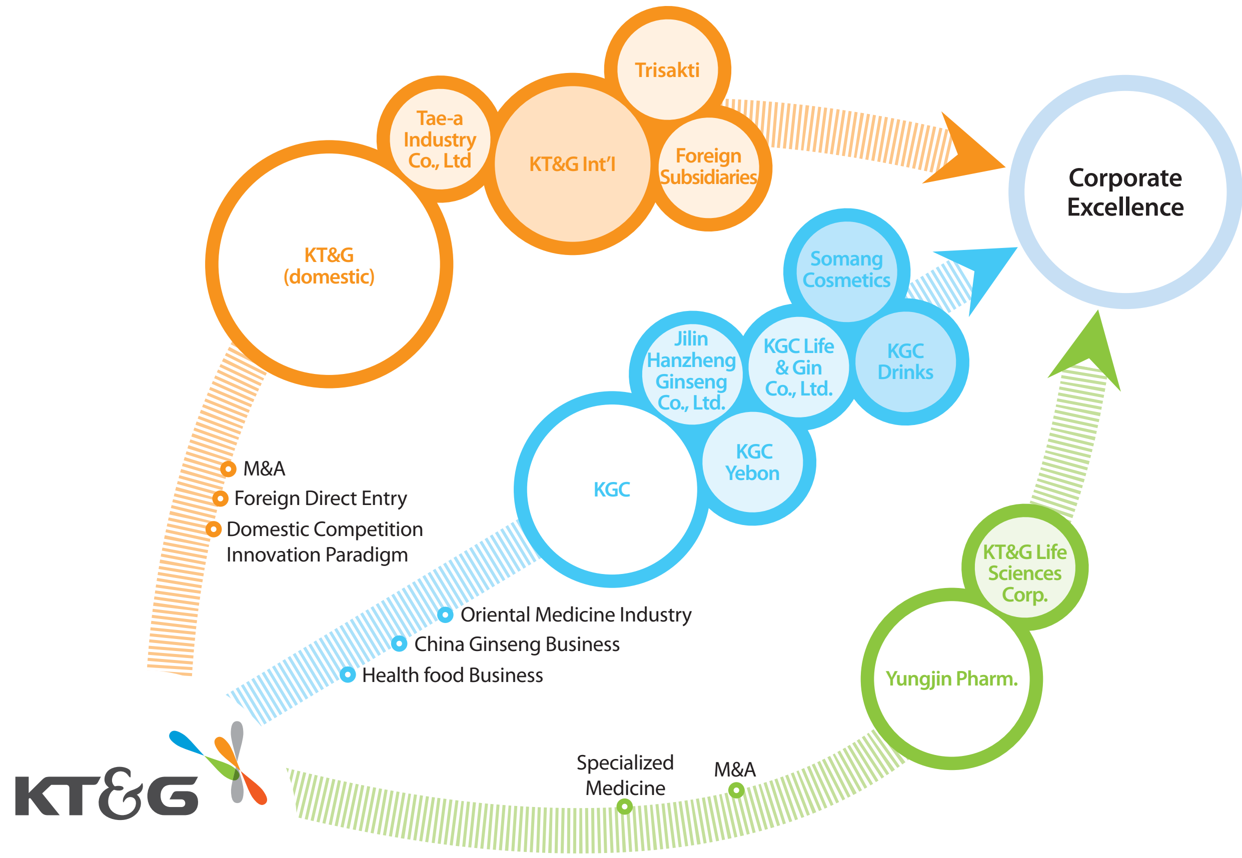
Challenge	Performance	Cooperative and Collaborative
People who constantly take on challenges - Passion for growth and inner satisfaction - Creative, not afraid of challenges - Able to lead change and innovation	People who are performance-driven - Making fact-based decisions - Producing quick and accurate outcomes - Being responsible and decisive	- Committed to working together for everyone's benefit - Group-oriented thinking - Team-centered - Respectful of diversity, open-inded

Developing a creative and forward-looking corporate culture

KT&G is committed to the development of a creative and forward-looking corporate culture that measures its goals from a long-term perspective. Our management decisions and strategic tasks for sustainable growth are based on a belief that a business' growth is ultimately determined by the quality of its employees. As a result, we value human resources who are talent-oriented, welcome challenges, and are performance-driven, cooperative, customer-centered, and dedicated to ensuring mutually beneficial growth with our business partners. In our role as the world's fifth-ranking tobacco company, our overriding goals are to create value through open, honest, transparent, and ethical management and to help create a better world for everyone.

Our goal is to be an honest and transparent company that prizes change and innovation, sharing and caring, and employee autonomy and creativity. Our greatest priority is to create value for our stakeholders and fulfill our obligations to society.

KT&G's Medium- and Long-Term Business Strategy



KT&G: A high-net-worth global company

KT&G's strategy of building a well-balanced business portfolio is designed to mitigate the possibility of slowdowns in the growth of its existing businesses and support the growth of its new ones. This includes expanding into new markets and forming strategic alliances with overseas companies. Our goal is to grow into a "high-net-worth global company" with guaranteed growth potential and profitability.

KT&G's mid- to long-term strategic direction until 2015 is to grow into a high-net-worth company with guaranteed growth potential and profitability. We will accomplish this by adding to the competitiveness of our core brands, enhancing our consumer-oriented marketing techniques, maintaining and increasing our market share in Korea, and focusing on operations that are both stable and profitable. In addition, we will transform ourselves into a truly global player by expanding into new markets and forming strategic alliances with overseas companies.

Taking steps to strengthen our existing businesses

In order to overcome slowdowns in the growth of our existing businesses, we will continue with our strategy of overseas expansion. We will also strengthen our competitiveness so that we can add to our market dominance. This will enhance our profitability and add to our potential for growth.

Adding to value of new growth engines

We will strengthen the foundations of our new growth engines by working from our core capabilities. In addition, we will add to our potential for growth by improving our management efficiencies and integrating and upgrading our infrastructures.

Strategies and Management Goals by Business

KT&G is committed to enhancing the competitiveness of its core businesses and adding to the value of its new growth engines scale. This will be done by reducing our dependence on our domestic tobacco business and increasing the relative weightings of our overseas tobacco, red ginseng, and health-related businesses.

In order to implement our mid- to long-term strategies as effectively as possible, we will continue to develop a performance-driven corporate culture through change and innovation. We will also take steps to reorganize our methods of corporate governance so that they are better structured to rebuild our business portfolio in the long term. In addition, we will make dramatic changes to our infrastructures to support the conversion of our business portfolio so that it is focused on growth.

Domestic Tobacco Business

We plan to continue supporting our very profitable domestic tobacco business, even though its market is shrinking. This includes increasing its market share and enhancing its profitability. In order to strengthen our fundamentals for the long term, we will devise strategies that can change competition paradigms.

Overseas Tobacco Business

Our growth strategies will include advancing into new markets and forming strategic alliances with their domestic tobacco companies.

Red Ginseng Business

We will add to our superiority in the market in terms of both quality and brand. This will include strengthening our position as a leading player in the domestic market. Overseas, we will strengthen our presence and diversify our products and markets.

Health-Related Business

We will raise the status of our health-related business by taking advantage of our strengths in such areas as contract farming, high quality, safety, and efficient distribution. All of these steps will combine to strengthen our position in the market

- Health functional foods

Increase customer trust by using KGC quality certifications, and strengthen position in domestic market by expanding product portfolio and distribution network

- Cosmetics

Lead the market for highly-functional, premium herbal osmetics by adding to portfolio of new products. Strengthen position in cosmetics sector by revamping Somang Cosmetics' brand and distribution channel strategies and adding to its production and R&D capabilities.

- Medicinal herbs

Gain an early edge in the market by developing a stable upply of reliable, standardized, and high-quality raw materials to grow into a company specializing in agricultural and high-value-added natural materials

Bio and Pharmaceutical Business

We will maximize synergies by utilizing the R&D capabilities of KT&G Life Sciences. In addition, we will strengthen the growth foundations of Yungjin Pharm. by enhancing its competitiveness in the domestic market and adding to its global operations.

- KT&G Life Sciences Corp.

Improve operating results by developing innovative new medicines and carrying our more global licensing.

- Yungjin Pharm.

Focus on manufacturing bulk products, launching new ones, and improving product portfolio in the domestic market. Increase presence in the overseas market by expanding range of antibiotics and other high-profit products.

Business Review and Global Businesses - Tobacco

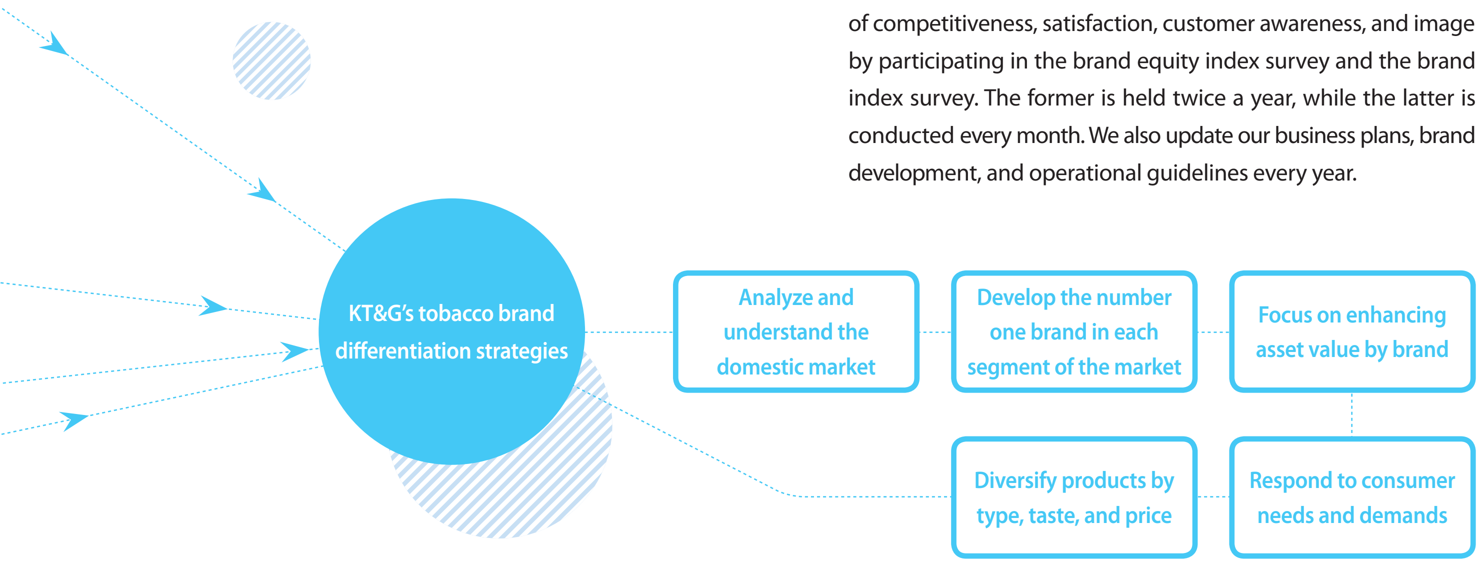
Strengthening our corporate and market competitiveness

KT&G's drive to become a leading global brand in the tobacco market is based on a strategy of stable growth and building a broad range of business portfolios. This includes aggressive overseas expansion and creating the highest possible value in our various new growth engine businesses.

Enhancing Brand Value

KT&G is focused on enhancing the value of its brands. This includes developing the number one brand in each segment of the domestic tobacco market. We are also responding to the needs and demands of consumers by making continuous improvements to our brand products. For example, we are building a wide range of portfolios for our products by type, taste, price, and design.

In addition, we measure our overall brand performance in terms of competitiveness, satisfaction, customer awareness, and image by participating in the brand equity index survey and the brand index survey. The former is held twice a year, while the latter is conducted every month. We also update our business plans, brand development, and operational guidelines every year.

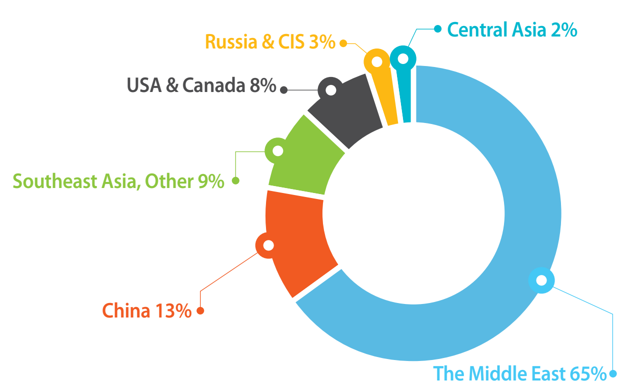


Investing in World Markets

KT&G exports about seventy tobacco brands to forty-nine countries and regions around the world, including the Middle East, Central Asia, and Russia. We currently operate branches and subsidiaries in China, Indonesia, the USA, Iran, Russia, and Turkey. In order to boost our supply of raw materials, we have established factories in Iran, Russia, and Turkey.

They produce and sell our major brands, such as ESSE and Pine. We also took over the operations of an Indonesian tobacco firm, called Trisakti, through an M&A in 2011.

Overseas Sales by Region



※Including overseas subsidiaries, as of December 2012

Participating in the TFWA World Exhibition

We have been participating in the Tax-Free World Association Exhibition since 2006 as part of our PR activities for our flagship overseas market brands, including ESSE. This assists us in entering new markets by improving our brand image and strengthening our relationships with current and potential clients.

ESSE: World-Class, Number One Brand

- Sold 2.11 billion packs in 2011
- Ranked first in sales in global ultra-slim tobacco market in 2012
- Ranked first in tobacco category in the Korea Brand Power Index survey from 2008 to 2012
- Ranked first in the National Brand Competitiveness Index survey from 2010 to 2012

Enhancing Competitiveness through Business Diversification

KT&G is growing into a high-net-worth company by building a balanced business portfolio that includes our red ginseng business, our household and health care business, and our bio and pharmaceuticals business.

Growth with Affiliated Companies

Red Ginseng Business

Our activities in this area include expanding overseas and enhancing our local marketing activities. In addition, we are diversifying our business areas to include other health foods and health-oriented services.

Cosmetics Business

We are a leader in Korea's premium herbal cosmetics market, adding to our dominance through continuous investments in R&D, advanced production methods, and state-of-the-art distribution channels.

Health-Related Business

We offer our customers a wide range of total health solutions in our chain of new-concept herbal life stores. Our products include highly efficient premium herbal cosmetics and custom-tailored, scientifically-based health functional foods. We also sell our goods door-to-door.

Bio and Pharmaceutical Business

Our goal is to develop new and exciting products by making strategic investments in this next-stage new growth engine business. Although we are already generating over 30% of our sales overseas, we are seeking additional market opportunities in China, Southeast Asia, and the CIS.

Growth with Affiliated Companies

Korea Ginseng Corporation

KGC has been producing Cheongkwanjang, a premium red ginseng product, since 1899. It is now adding to its status as the world's number one red ginseng company by taking on a number of globalization activities.

1 Cheongkwanjang
2 Goodbase
3 Yebon

KGC Life & Gin

KGC Life & Gin provides total health solutions based on traditional herbal medicines.

1 Boum: Herbal Life Store
2 Donginbi: Red Ginseng Cosmetics
3 Eche: Door-To-Door Sales
4 Überex: Medical Foods

Somang Cosmetics

Somang Cosmetics has enjoyed continuous sales growth through the development of reliable products and breakthrough marketing strategies.

1 Danahan: Herbal Cosmetic Brand
2 Man with Flower: Living Beauty Care Brand
3 ONL: Beauty & Lifestyle Shop

Yungjin Pharm.

The company is a strong in the fields of generic medicines, improved new medicines, and new phygomedicines. It is also very active in conduct-ing R&D into biomedicines.

1 Health drink
2 Enteral nutrition
3 Medicine

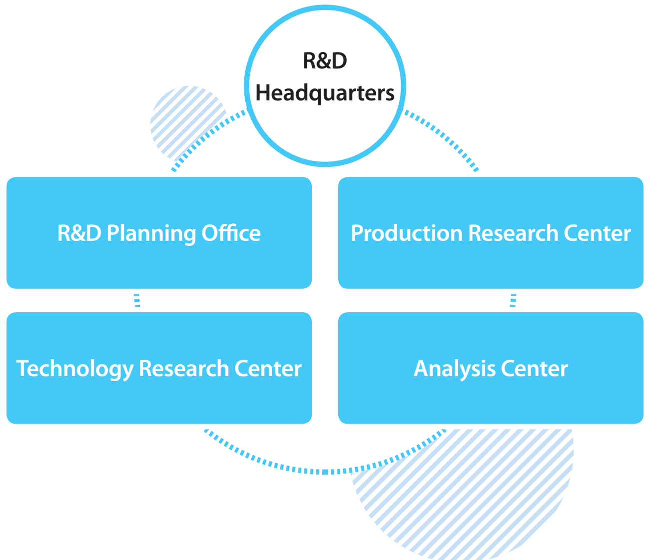
Product Liability and Quality Competitiveness

Research and Development

KT&G is making major R&D investments into reducing the health risks of smoking and improving the quality of its products. Its R&D headquarters is tasked with enhancing the brand value of our products and meeting the constantly diversifying needs of our customers.

R&D Organization

KT&G's R&D Headquarters consists of the R&D Planning Office and three research centers. The R&D Planning Office develops the company's R&D strategies and goals and carries out projects to achieve them. Our Production Research Center is tasked with developing new products and upgrading existing ones to reflect our customers' ever-changing needs. The Technology Research Center conducts research into key technologies in the areas of tobacco farming and tobacco products for the development of innovative new products. The Analysis Center focuses on research into analytical techniques that are needed to develop new products and technologies.



Intellectual Property Rights

KT&G owns a number of patents in a variety of areas, including product manufacturing technologies, process technologies, and materials technologies.

Quality Competitiveness

Double-Wrap Technology: This technology double-blocks side-stream smoke that is generated when a cigarette burns by using two layers of paper instead of one. This also helps to reduce the cigarette smell that seeps onto people's clothes and hands when they are smoking.

Aroma Generating Packaging Material: This refers to micro capsules containing a special aroma that has been applied to the cigarette package. The aroma is emitted when the package is rubbed, reducing the amount of cigarette smell on people's hands.

Taste and Quality Guarantee System: This system immediately stops our production lines when a problem occurs and restarts them when the difficulty has been resolved.

Double Inspection System: Our product quality analyses include sensory evaluations by teams of skilled professionals and state-of-the-art equipment to monitor our products when they are ready to be shipped.

Producer Identification Inscription System: We were the first tobacco company in the world to inscribe our business name on all our products. At the present time, it applies only to products that are sold in Korea. We are doing this to increase our customers' confidence in the quality of our products. In addition, we encourage our workers to exercise the highest-possible quality control over their products by printing production information and the names of our team leaders at the bottom of our cigarette packages. This has been happening since August 2011. We are also developing internal processes to evaluate the effectiveness of this system and improve it.

Consumers' right to know: As per the requirements of the Korean government's Tobacco Business Act and National Health Promotion Act, we include health alerts and warnings on all our advertisements and all our cigarette packages that are sold in Korea. We do the same thing with all the products that we export, in line with the rules and regulations of each country in which they are sold. This even includes countries in which such alerts and warnings are not legally called for. In addition, we abide by all international rules and regulations regarding the clear and easily understandable labeling of consumer products. This includes listing the tar and nicotine levels of all our products.

KT&G Brand and Technology Innovation

Developing leading global brands through technology and innovation

KT&G sells its products in a variety of formats and price ranges designed to satisfy each and every customer. Our portfolio of both new and familiar products is based on the results of our ongoing R&D activities and market surveys. We do this to maximize customer satisfaction with our products and to enhance the status of our brand in both the domestic and overseas markets.

We recognize that the concepts and designs of tobacco products are important factors for determining customer satisfaction. We are enhancing our business competitiveness by providing a wide variety of prime-quality products with unique concepts and designs that can maximize consumer satisfaction levels.

Technology Innovation Products

Reconstituted tobacco sheet development technology (Improving recycling rates): This technology raises the recycling rate of our tobacco by-products while helping to enhance the tastes of the products themselves.

TONINO LAMBORGHINI: contains expensive 'smoking leaf', premium tobacco blended with European Orient to create a cigarette characterized by a soft throat and enriched taste. It also applied the highest available quality features for the first time in Korea, such as double OPP film for superior moisture retention and an embossed lip release filter.

THE ONE Etipac (Low sidestream smoke-reducing technology / Microcapsulation technology): The first technology blocks side-stream smoke dramatically. The second one enables special aromas contained in micro capsules to be emitted when the package is rubbed.

ESSE SENSE (Filter differentiation technology): This technology applies spatial filters to this ultra-slim product. A first in Korea.

BOHEM CIGAR CUBANA DOUBLE (Menthol differentiation and boosting technlogy): Part of the aroma is encapsulated, delivering more refreshing feelings depending on consumer tastes.

R&D Product Strategies

- Develop eco-friendly technologies
- Research into the development of products to reduce health risks
- Develop differentiation technologies to improve quality

Eco-Friendly Management

We practice eco-friendly management by reducing our environmental impact, supplying high-quality products through a broad range of technology innovations and development activities.

Aiming to be a leading global brand

We sell about seventy types of brands to the Korean market and export our products to forty-nine countries and regions, including the Middle East, Central Asia, and Russia. Our goal is to grow into a leading global brand.

Major Products

ESSE Series:
One of the world's most popular ultra-slim tobacco products, and a constant best-seller in Korea.

BOHEM CIGAR series:
A brand that appeals to sophisticated consumers. Contains 20~30% premium cigar leaves for a unique taste and aroma.

RAISON Series:
The most preferred brand among young Koreans.

THE ONE Series:
A mild brand whose filter particles have been double-treated with oxygen.

THIS PLUS Series:
Another brand that is popular with young people.

ESSE SENSE:
An ultra-slim product to which spatial filters have been applied. Another first in Korea.

BOHEM CIGAR CUBANA DOUBLE:
A menthol product containing 20% cigar leaves and featuring a Cuban aroma. Part of the aroma is also encapsulated, delivering more refreshing feelings depending on consumer tastes.

RAISON PRESSO:
It took four years to develop this product, offering distinctive flavors with a deep and rich aroma.

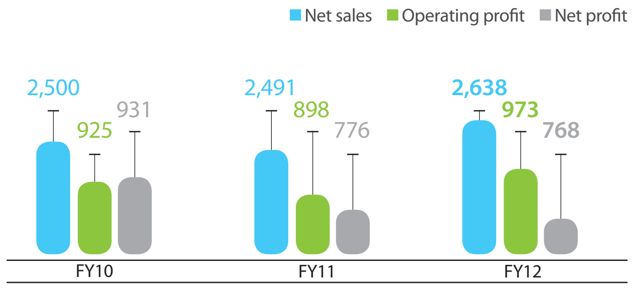
TONINO LAMBORGHINI:
Tonino Lamborghini cigarettes are the fruit of a collaborative effort between KT&G and the Italian luxury brand Tonino Lamborghini and are designed to reach a global market.

Operational Review

Economic conditions in Korea and abroad were highly unfavorable in 2012, mainly due to ongoing sovereign debt crises in the Euro zone and stagnant business activities at home.

Despite these difficulties, we managed to raise our market share in Korea by 3 percent by launching a number of new and exciting brands, including RAISON Presso. Sales increased by 5.9% over the year to KRW2,637.6 billion. Operating profit surged by 8.3% to KRW972.7 billion, thanks to cost control activities in such areas as labor productivity and our production facilities. Net profit fell by 1.0% to KRW768.4 billion.

Sales & Profits



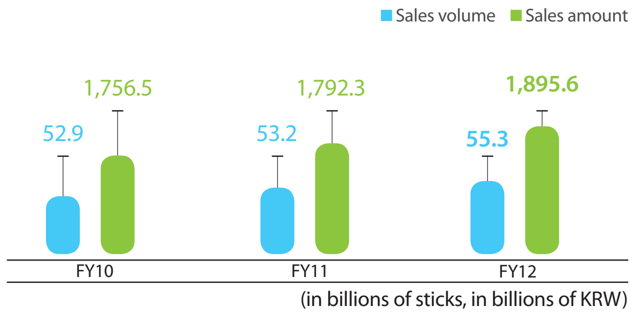
Domestic Tobacco Business

Korea's challenging market environment continued over the year, mostly due to intensifying competition and the constantly-changing demands of our customers. In order to cope with this situation, KT&G launched a wide range of new and exciting products to meet differing customer needs and increase our brand power. They included ESSE Sense, ESSE Ice 1mg, Bohem Cigar Cubana Double, Raison Aero, Raison Presso, and Cloud9 Slims.

- ESSE Sense, which applied the Airgrip Filter to our market-leading ultra-slim ESSE brand;
- ESSE Ice 1mg, which applied the highest-grade natural menthol;
- Bohem Cigar Cubana Double, a menthol product containing 20% cigar leaves and featuring a Cuban aroma;
- Raison Aero with the Airgrip Filter embedded;
- Raison Presso, a product offering distinctive flavors with a deep and rich aroma;
- Cloud9 Slims which tastes mild by adding quince aroma.

In addition, we strengthened our sales performance and efficiencies by integrating our domestic operations in such areas as marketing, sales, manufacturing, procurement, and R&D. We also laid the groundwork for smart sales activities by introducing new devices. As a result of these efforts, our sales volume increased by 3.9% over the year. In addition, the sales ratio of our high-priced, high-profit products to our total sales increased by 1.8% points, leading to a 1.6% rise in our average selling price.

Domestic Sales



Overseas Tobacco Business

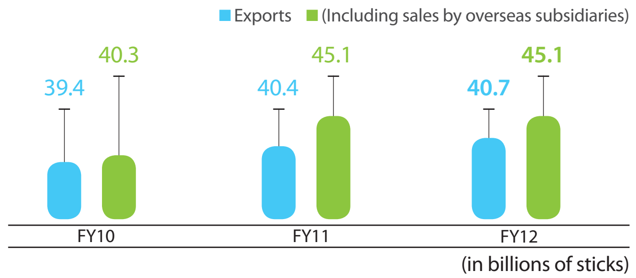
Our export sales volume grew by 0.8% to 40.7 billion sticks, while our sales value rose by 5.1% to KRW628.2 billion. We posted KRW200.6 billion in operating profit, despite the disadvantage of an appreciating Korean won. Much of this success resulted from increases to our advertising and promotional budgets and an expansion of our distribution facilities in key markets like the Middle East, Central Asia, and the CIS. We also pursued sales volume and market expansion in the Asia-Pacific market.

Sale by our overseas subsidiaries increased significantly. Total overseas sales volume, including exports and sales by our overseas subsidiaries in Russia, Turkey, and Iran, amounted to 45.1 billion sticks, remaining at the previous year's level. Total overseas sales were KRW710.1 billion, up 4.1% YoY.

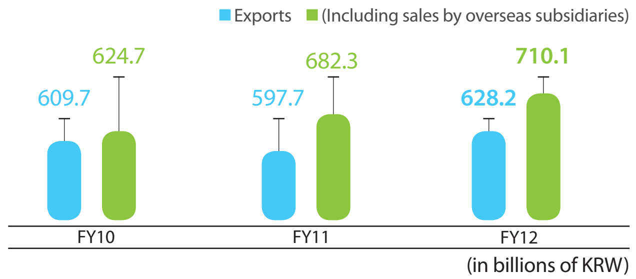
We are making substantial investments in overseas markets with a promising potential for growth, such as the CIS and Russia. In addition, we are expanding our distribution channels in China, Indonesia, and other countries in Southeast Asia, and advancing into new markets in Europe, Africa, and Central and South America.

Overseas Sales

Volume



Amount



Production and Procurement

We are adding to the production capacity of our Shintanjin factory on a stage-by-stage basis. This is being done to enhance our mid- to long-term manufacturing competitiveness and develop high-quality, high-efficiency production infrastructures. We have also increased the productivity of our workforce there, partly by outsourcing many of our low-value operations. As a result, our labor productivity at the factory grew by 4.4%.

We have also developed a number of eco-friendly strategies. They include using recyclable materials in our packaging papers and building a low-carbon, green production line that includes reusing surplus energy produced by neighboring companies.

KT&G's purchases the highest-quality tobacco leaves and other raw materials possible, both in Korea and from abroad. We were able to lower our average per-unit purchasing price compared to the previous year by taking advantage of dramatic changes in world prices for tobacco leaves. In addition, we took steps to guarantee a stable supply of raw materials by undertaking a number of local production projects and signing long-term supply contracts. We also strengthened our foundations for overseas growth by finding markets for our reconstituted tobacco sheets.

We enhanced the efficiency of our supply chain by introducing a Supplier-Quality certification system. In addition, we added to our negotiating and purchasing power by establishing an integrated and joint raw materials purchasing program.

Real Estate Business

The primary focus of our real estate business is to maximize the value of our holdings and strengthen our revenue and growth foundations. In 2012, this included completing and leasing two office buildings in Daechi-dong and Seodaemun, Seoul to maximize the value of our idle properties. We also disposed of 18 properties. We generated sales of KRW33.6 billion (a rise of KRW11.0 billion over the year) from the operation of our income-producing properties.

Financial Review
(Management Discussion and Analysis)

KT&G's financial statements are prepared based on Korean International Financial Reporting Standards (K-IFRS). This means that they fulfill all the requirements of the International Accounting Standards Board, as per Article 13 of the Korean government's Act on External Audit of Stock Companies.

The information presented herein contains statements regarding the company's financial condition, operating performance, and business purposes and plans. Since such forward-looking statements involve known and unknown risks, uncertainties, and other factors that are not within the control of the company, its actual results and/or performance may be materially different from anticipated future results or performances that are either expressed or implied in these statements.

KT&G does not assume any responsibility for the accuracy or completeness of the information contained or implied in this section, and statements regarding the past or the future must not be construed as constituting promises or claims. The information given herein is based on the company's plans, estimations, and projections, as well as assumptions considering the political and economic environment in Korea and other countries in which the company currently operates or may operate in the future. Such estimations and projections can also be altered due to changes in the operating environment. As a result, readers of this report should take reasonable care before relying on the information contained herein. Estimates, plans, and projections are based on conditions on the day this report was prepared. KT&G does not bear any responsibility for providing additional information regarding future events. The term "company" as used herein and without any other qualifying description refers to KT&G.

Executive Summary

In 2012, KT&G took a number of steps to guarantee stable results and earnings in the midst of a very difficult operating environment. Some of the problems that it faced included an ongoing global financial crisis and lowered consumer demand for tobacco products both inside and outside Korea.

The company recorded sales of KRW2,637.6 billion in its tobacco, real estate, and other businesses, up 5.9% from the previous year. Gross profit and operating profit edged up by 8.7% and 8.4%, respectively, to KRW1,655.5 billion and KRW972.7 billion. This reflected growth in sales of mid- to high-price products and a concomitant rise in the average selling price.

Selected Financial Data

	FY10	FY11	FY12	% YoY
Net sales	2,500	2,491	2,638	5.9
Gross profit	1,498	1,524	1,656	8.7
Operating profit	925	898	973	8.3
Net profit	931	776	768	(1.0)
Total assets	5,254	5,418	5,918	9.2
Total liabilities	916	874	1,015	16.1
Total shareholders' equity	4,338	4,544	4,903	7.9
Gross margin (%)	59.9	61.2	62.8	1.6%p
Operating margin (%)	37.0	36.0	36.9	0.9%p
Net margin (%)	37.2	31.2	29.1	(2.1%p)
EPS(KRW)	7,317	6,134	6,111	(0.4)
PER (X)	8.8	13.3	13.2	(0.1)
Stock Price(Year-end)(KRW)	64,700	81,400	80,800	(0.7)

(in billions of KRW)

Analysis of Operating Results

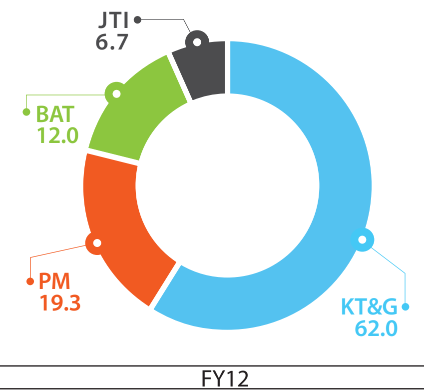
Summarized Income Statement

	FY10	FY11	FY12
Net revenue	2,499	2,491	2,638
Gross profit	1,498	1,524	1,655
Operating profit	925	898	973
Net profit	931	776	768

(in billions of KRW)

Sales increased by 5.9% YoY to reach KRW2,637.6 billion at the end of the year. Gross profit and operating profit margin increased by 8.7% and 8.3%, respectively, to KRW1,655.5 billion and KRW972.2 billion, outperforming the growth in sales. This resulted from our various efforts to cut costs and increase our operating profit. These included revamping our Shintanjin factory to ensure a higher-quality, higher-efficiency production base, expanding our range of mmedium- to high-priced products, and raising the average selling price.

Domestic Market Share



(%)

The tobacco market is changing rapidly. This reflects the constantly changing tastes of consumers and intensifying competition for new products. In order to respond to such an environment effectively, KT&G took a number of steps. They included pursuing integrated marketing strategies, launching differentiated products that meet the needs of the market, and strengthening its Esse lineup to retain its dominant position in Korea's ultra-slim tobacco market. As a result, the company's market share continued to expand, recording 62.0% in 2012.

Operating Revenue

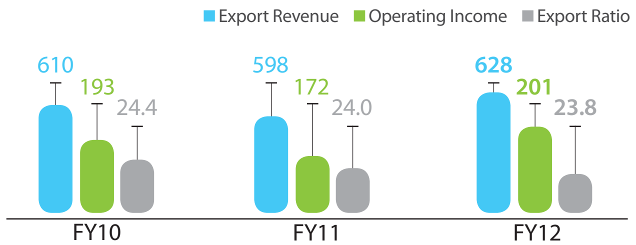
Net ASP / per pack and premium brand ratio

	FY10	FY11	FY12
Net ASP/per pack (KRW)	663.8	674.4	685.4
Premium brand sales (in millions of sticks)	37,895	39,138	41,745
Premium brand sales to total domestic sales	71.6	73.6	75.6

* Premium brand retail price: KRW2,500 and the above (%)

The development of a variety of brands and the brand value of individual products are very necessary, since the market is continuing to segment. The company is making efforts to develop products with different tastes, prices, and designs, using prime-quality raw materials and state-of-the art automated facilities. This means that the sales ratio of our premium brands and their average selling price have both increased, allowing them to play an ever-larger role in our profitability.

Exports



(in billions of KRW, %)

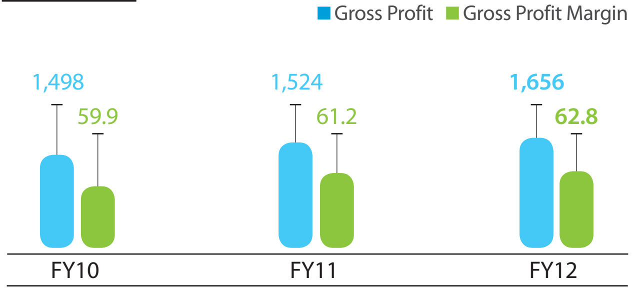
Our tobacco exports recorded sales of KRW628.2 billion, up 5.0% from the previous year, despite the continuing appreciation of the Korean won. Operating profit was KRW200.6 billion, a rise of 16.9%, significantly outperforming growth in sales. This success resulted from our aggressive marketing strategies, including adding to our adverting and promotional investments and expanding our distribution coverage in our key markets of the Middle East, Central Asia, and the CIS.

This growth in exports should continue due to continuing investments in new and potential markets such as Europe, Africa, and Central and South America and the enhanced promotion of our existing markets.

Financial Review
(Management Discussion and Analysis)

Operating Profitability

Gross Profit



(in billions of KRW, %)

We increased productivity and reduced our costs. This was done by optimizing the efficiency of our facilities, such as making improvements at our factory in Shintanjin, expanding our flexible manufacturing system, and encouraging constant innovations at all our worksites. As a consequence, our gross profit advanced by 8.7% over the year to KRW1,655.5 billion, while our gross profit margin improved by 1.6% points.

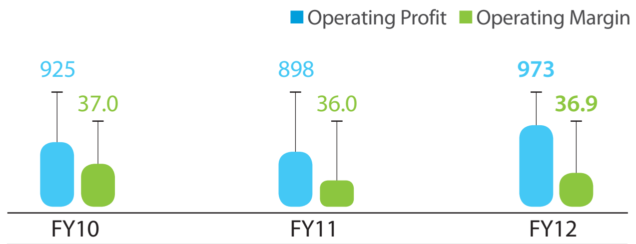
Breakdown of SG&A expenses

	FY10	FY11	FY12	% YoY
SG&A Expenses	631	626	683	9.1
Salaries	174	207	221	6.8
Employee Benefits	19	25	28	12.0
Advertising	176	158	174	10.1
Depreciation Expenses	40	34	33	(2.9)
Other Expenses	222	202	227	12.4

(in billions of KRW, %)

Sales, general, and administrative (SG&A) expenses increased by 9.1% over the year to KRW682.8 billion. This was mainly caused by a rise of 10.1% in advertising to KRW158.4 billion and increases in salaries and employee benefits. Another factor was a one-time bad expense that did not affect the company's fundamentals.

Operating profit

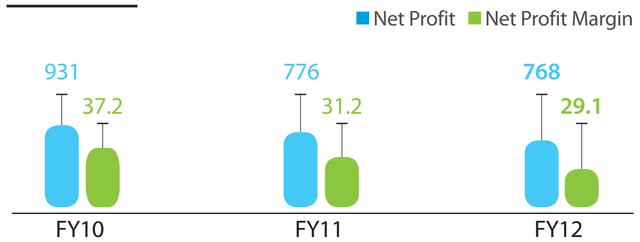


(in billions of KRW, %)

Our operating profit increased by 8.3% to KRW972.7 billion. This resulted from a rise in our gross profit and despite an increase of 9.1% in our SG&A expenses. Our operating profit margin went up by 0.9% points to 36.9%.

Earnings and Dividends

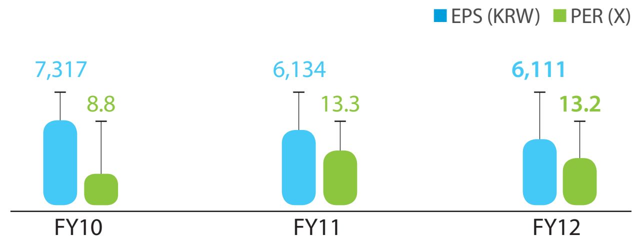
Net Income



(in billions of KRW, %)

Net profit fell to KRW768.4 billion, despite a 8.4% increase in operating profit. This was mainly due to a rise in foreign currency translation losses and a decline in our net financial income over the year. This also led to a drop of 2.1% points in our net profit margin, to 29.1%.

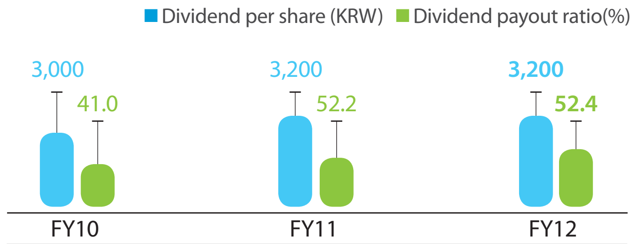
EPS & PER



Note: The share price shown is that at year-end.

Earnings per share declined by 0.4% YoY, remaining similar to the previous year's level. The share price inched down slightly to KRW80,800 based on the year-end closing price. The price-to-earnings ratio was 13.2 times, similar to the preceding year.

Dividend per share & Dividend Yield



Note: The share price shown is that at year-end

KT&G is committed to maximizing its corporate value, returning cash that it has generated through its business operations to its shareholders in a fair and equitable manner. In 2012, we paid a dividend of KRW3,200 per share, the same as the previous year. This was done even though our net profit decreased.
The dividend translates to a payout ratio of 52.4%. Based on our year-end closing share price of KRW80,800, the dividend yield ratio was 4.9%. KT&G will continue its policy of maximizing shareholder value going forward.

Financial Condition Analysis

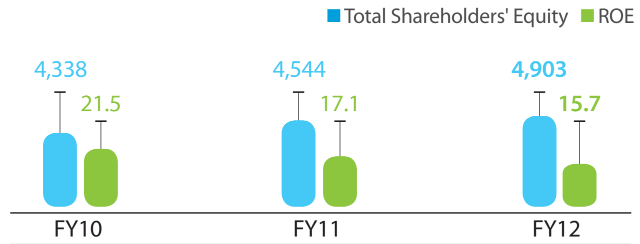
Summarized Statements of Financial Position

	FY10	FY11	FY12	% YoY
Total assets	5,254	5,418	5,918	9.2
Total liabilities	916	874	1,015	16.1
Total shareholders' equity	4,338	4,544	4,903	7.9

(in billions of KRW, %)

Total assets increased by 9.2% over the year to reach KRW5,917.9 billion at the end of 2012. This growth was backed by stable sales growth and our increasingly successful overseas business. Total liabilities grew by 16.1% to KRW1,014.6 billion. This was mainly caused by a temporary rise in the tobacco consumption tax and short-term trade payables. Total shareholders' equity increased by 7.9% to KRW4,903.3 billion. This resulted from a rise in retained earnings due to an increase in our net profit, as well as our efficient management of our reserves.

Return on Equity



(in billions of KRW, %)

Our return on equity fell by 1.4% points from the previous year to 15.7%, reflecting a rise of 7.9% in total shareholders' equity and a slight decline in net profit.

Cash Flow Analysis

Summarized Statements of Cash Flow

	FY10	FY11	FY12
Cash flow from operating activities	716	662	801
Cash flow from investment activities	173	(351)	(784)
Cash flow from financing activities	(329)	(500)	(389)
Net increase (decrease) in cash and cash equivalents	560	(190)	(372)
Cash and cash equivalents at year-end	829	639	267 (%YoY 58.2)

(in billions of KRW, %)

Net cash flow from our operating activities went up by 21.0% to KRW800.9 billion, due to smaller gains on the disposal of assets. This was due to the inflow of net working capital and YoY increases in both sales and operating profit.

Cash flow from our investment activities ballooned by 123.4% to KRW784.3 billion. This was mainly driven by investments in business diversification and rises in deposits and trusts. As a result, cash and cash equivalents at the end of the year fell by 58.2% to KRW266.7 billion from KRW639.1 billion at the previous year-end.

2013 Business Plans and Outlook

In 2013, the global economy will probably continue experiencing sovereign debt crises in the Euro zone and economic recovery problems in the USA and China. In Korea, management uncertainties will likely persist due to ongoing volatility in terms of both exchange rates and prices.

Given this uncertain operating climate, KT&G Group will continue with its strategy of pursuing a balanced business portfolio that focuses on growth and profitability. To this end, we will create value from new growth engines, and strengthen our operational structure to cope with slowing growth in our existing businesses.
This will include enhancing the competitiveness of our existing businesses, producing full-scale results from new growth ones, and continuing with our advance into overseas markets.

In terms of our domestic tobacco business, we will concentrate on adding to the competitiveness and profitability of our brands, strengthening our consumer marketing activities, and increasing our forward-looking strategies.
We will reorganize our portfolio with a focus on our strategic brands, continue with our strategy of developing industry-leading brands, and increase our average selling price by adding to our portfolio of higher-priced products. Our consumer marketing activities will continue to center on our products' taste, quality, and eco-friendliness. We will also gain an early edge in new markets by strengthening company-wide integrated consumer communications and concentrating our marketing for key target groups.

In terms of our overseas tobacco operations, we will continue growing into a truly global enterprise by advancing into new markets and enhancing the competitiveness of our global operations.
We will strengthen our presence in our key markets and increase growth in our existing markets by invigorating them by region. Our entry into new markets will be made through a combination of direct advances, strategic alliances or M&As. In the Indonesian market, we will activate local production and systematize our distribution management.

With regard to our red ginseng business, we will retain our dominance of the domestic market by adding to our competitiveness. We will also strengthen the foundation of our overseas markets and subsidiaries and continue diversifying our products and markets.
In Korea, we will strengthen our competitiveness and improve our revenue structure by promoting our strategic products, adding to our portfolio of highly functional products, re-establishing our roles by distribution channel, differentiating our brand management strategies, and building a Healing Center. We will also consolidate the mid- to long-term stability of our raw materials procurements, identify promising new raw materials, and advance into service-combined businesses.

Overseas, we will strengthen the business foundations of our subsidiaries through enhanced localization strategies and differentiated promotions by nation. In addition, we will diversify our product and market portfolios by developing custom-tailored products and formulas and tapping into non-Chinese speaking countries. We will add to our presence in the Chinese market by obtaining approvals and permits for production by Jilin Hanzheng Ginseng, and beginning local production as soon as possible.

In terms of our health-related business, we will take advantage of our core competencies to become a market-leading company.
We will do this by reorganizing our business models so that they focus on health functional foods and brands, strengthening the product power of our herbal cosmetics products, and their door-to-door sales. We will also expand the medicinal herbs processing and business areas of our companies.

In addition, we will ensure a stable supply of high-quality raw materials by increasing our medicinal herbs farming and supply, acquiring more cultivation skills, and utilizing high-quality farms. We will improve our status in the cosmetics business by strengthening our brand portfolio and increasing our number of directly-run brand shops.

With regard to our bio and pharmaceutical business, we will increase our R&D capabilities and enhance the competitiveness of Yungjin Pharm. to lay the groundwork for new growth.
To do so, we will maximize synergies within the Group by enhancing our R&D pipeline. We will also strengthen our growth foundations by launching innovative new medicines and licensing our products globally. In addition, we will add to our competitiveness by upgrading our facilities and improving their production and operational efficiencies. We will continue to grow by expanding our global operations and diversifying our range of products, including antibiotics and non-antibiotics.

Finally, we will strengthen the profitability and synergy creation potential within the Group through efficient asset management and value maximization.

We will create synergies among the Group's businesses by building real estate infrastructures for its core businesses, maximizing the value of our properties, and improving the efficiency of their operations by undertaking new development projects. This will add to the profitability of the Group and increase its revenue foundations for sustainable growth.

The KT&G Group will continue to seek constant changes and innovations to its human resources and organizational culture in order to successfully implement its business strategies in 2013.

Creating economic, social, and environmental values

One step closer to a better Life, Global Player KT&G

Management Standards

Building an advanced corporate governance infra-structure

KT&G's advanced corporate governance structure includes shareholder-centered management and fair, honest, and responsible decision-making processes. They ensure that our operations and financial information are always open, transparent, and reliable.

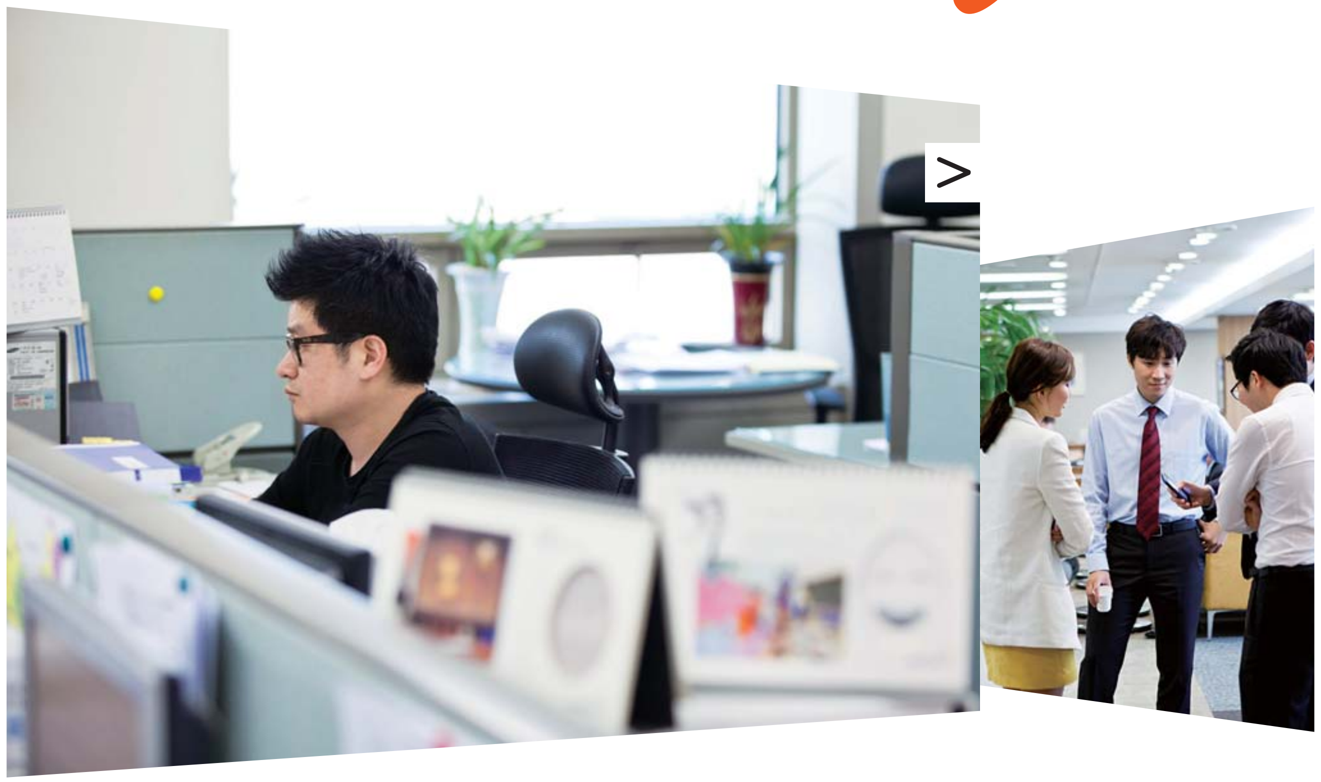
- Named Korea's best corporate governance company in 2011 by Corporate Governance Service

Composition and Functions of Board of Directors (BOD)

KT&G's commitment to an effective and efficient system of corporate governance includes an independently operating BOD. It consists of an executive director and eight outside directors. The qualifications of candidates for outside directors are reviewed by the BOD's Outside Director Candidate Recom-mendation Committee. The most qualified candidates are then recommended to a general meeting of shareholders. Another step that the company took to enhance the transparency of its management operations was to separate the role of the Chair of the BOD from that of the CEO of the company. This happened in March 2010.

BOD Committees

The Board of Directors includes a number of committees. They include a Strategy Committee, an Audit Committee, an Evaluation and Compensation Committee, and a Global Investment Committee. They have been established to enhance the expertise and openness of the Board and ensure that all the company's operations are fully transparent. The Audit Committee and the Evaluation and Compensation Committee are comprised of outside directors only. The Board of Directors met eleven times in 2012.



Open and Transparent Governance/General Shareholders' Meeting

All of KT&G's outside directors have access to information regarding the company's current management conditions. In addition, the Board and each of its committees conduct evaluations of themselves and their peers every year. The results are reported at the beginning of the following year. A general shareholders' meeting must be held within three months after the completion of each accounting period, while extraordinary general meetings can be called anytime.

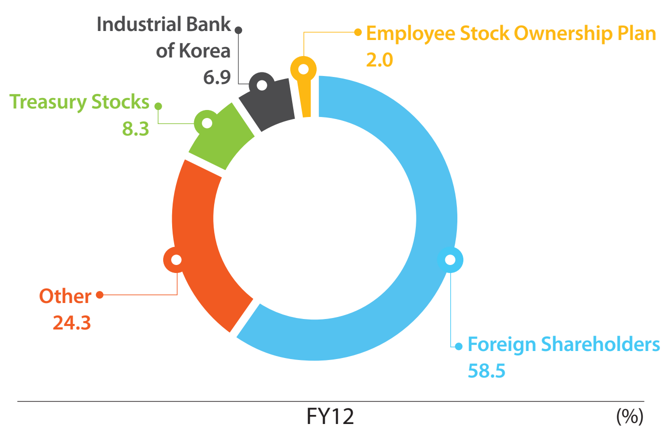
Maximizing Economic Benefits and Stakeholder Value

KT&G fulfills its economic responsibilities by fairly distributing value that has been created through its business activities to its stakeholders. In 2012, the company posted sales of KRW2,637.6 billion, sharing the revenue with its customers, shareholders, business partners, the central government, and the communities in which it operates.

Maximizing Shareholder Value

In its role as the world's fifth-largest tobacco company, KT&G is committed to maximizing shareholder value by continuously raising its corporate value. This includes building a balanced, market-leading portfolio across many different business sectors that will allow us to meet the needs of all our customers. We have been disclosing our financial statements (including the financial performances of our affiliates) by means of the International Financial Reporting Standards, or IFRS, since 2009.

Composition of Shareholders (%)



Management Standards

Investor Relations

KT&G carries out a wide variety of investor relations activities to enhance its level of communications with current and potential investors. They include road shows, conferences, forums, general IR sessions, and IR sessions targeting analysts and investors. We participate in IR conferences in Korea and other foreign cities.

Key IR Activities

IR sessions and materials

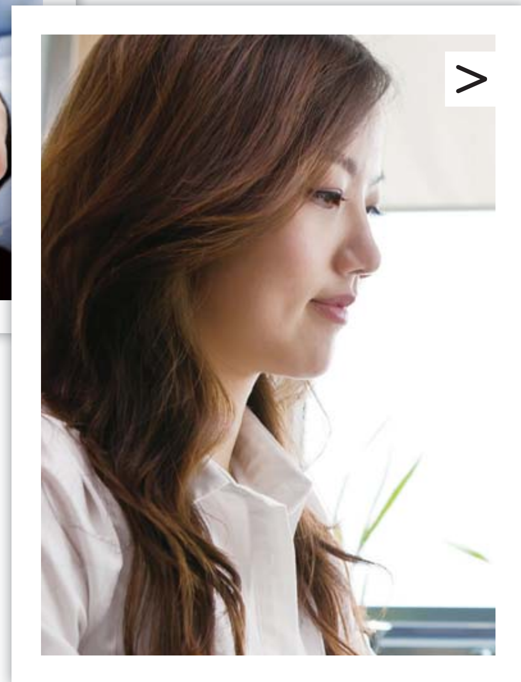
- IR sessions and materials (in both Korean and English)
- Conference calls with overseas investors
- Annual reports (in English)
- Group meetings for analysts
- Sustainability reports (in both Korean and English)

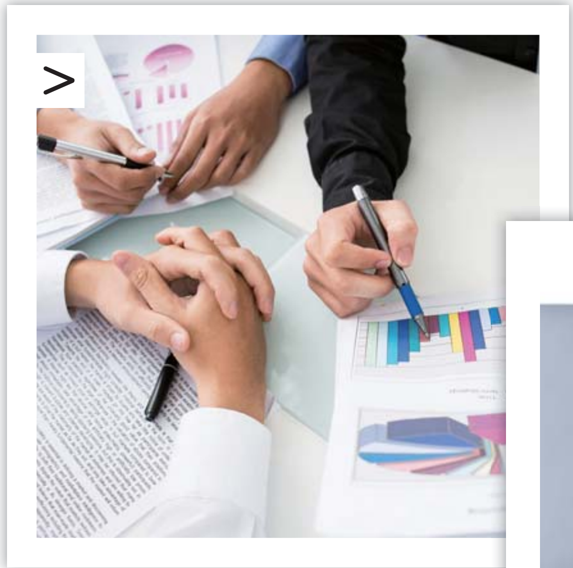
Road Shows

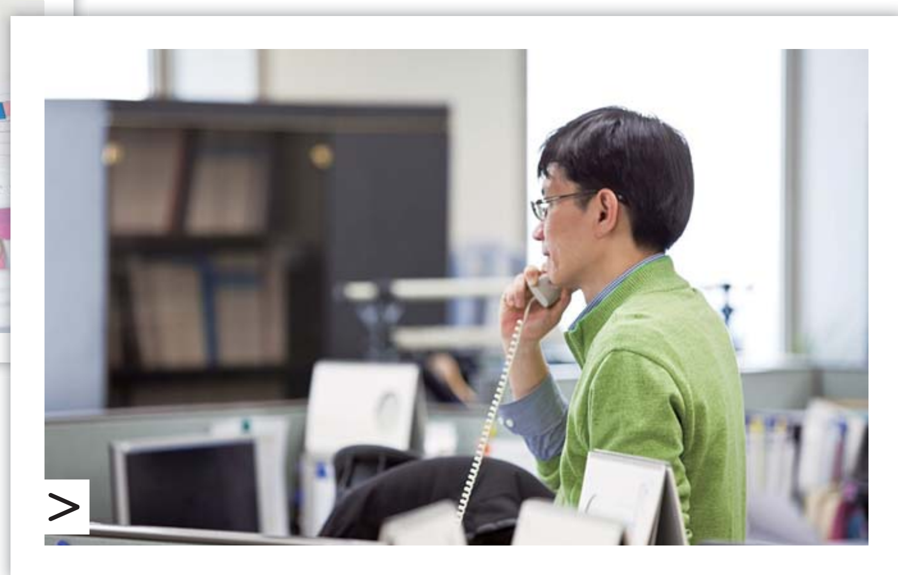
- Domestic and international road shows

Participation at conferences and forums in 2012

- JP Morgan CEO Conference, Citi Group Conference, RBS Securities Conference, Woori Investment & Securities Conference, Korea Investment & Securities Conference, Deutsche Bank Conference, Merrill Lynch Securities Conference
- Eugene Securities Forum







Customer Satisfaction Management

KT&G operates a wide array of communication channels. This allows us to listen to the voices of our customers more efficiently and provide them with better products and services.

Revamping the Customer Consultation Process

We pay strict attention to the voices of our customers (VOC) to ensure their satisfaction. For example, our cigarette packages include the telephone number of our Customer Service Center. It is open 24 hours a day to deal with customer complaints and problems quickly, fairly, and accurately. Our VOC office offers advice regarding people's health and our tobacco, marketing, and other policies. Another section deals with complaints regarding the quality of our products. Customer feedback on our VOC processes is forwarded to our Quality Management Office.

Reflecting Customer Opinions

Our Customer Service Center handles all our customer claims. It publishes daily and monthly reports of its activities, which are then shared with our brand managers. The Center also carries out a number of quality control training programs for its workers.

Customer Communication Channels

Website: We are continually strengthening the customer support part of our website. For example, we regularly update the FAQ section so that customers can find any information they need quickly and easily. Any questions that are not answered there can be addressed to us directly by calling our customer service center or sending us an e-mail.

Sinmungo: Our Sinmungo (or alerting device) system is another way that we interact with our customers. Any and all personal information that is collected on it or at our Customer Service Center is strictly protected in accordance with our Personal Information Protection Guidelines.

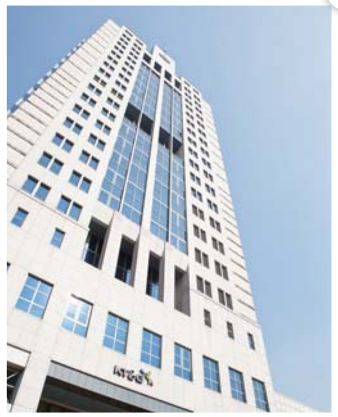
Outside Advisory Committee

We have been operating an advisory committee of outside experts since 2010. It held twenty-two regular meetings and fifteen ad hoc ones in 2012, discussing such topics as marketing, branding, and packaging designs. We also hold monthly lectures to identify changes in consumer trends and share information that we have accumulated.

Ethicial and Transparent Management

Ethical and Transparent Management

KT&G insists on open, honest, and ethical behavior among all its employees. We encourage our business partners to improve their human rights, labor, anti-corruption, and environmental protection practices. Those that do are presented with a "Supplier-Quality Certification Manual."



Putting Ethical Management into Practice

KT&G endeavors to gain the trust and respect of its customers and the larger society by fulfilling all its corporate social responsibilities and seeking mutually beneficial growth with all its stakeholders. We published our Code of Ethics and guidelines outlining the ethical standards we expect our employees to adhere to in 2003.

Ethical Management Organization and Functions

CEO

Ethical Management Office
- Establish corporate culture based on change and innovation
- Serve as bridgehead for the production of company-wide results

Ethical Management Department (5 persons)
- Disseminate and encourage the practice of the CEO's manage ment philosophy and core values
- Encourage the spread of a Group-wide ethical management culture (including training)
- Show employees good examples of ethical behavior
- Make improvements to practices, systems, and management efficiency

Take the lead in establishing a barrier-free, communications-oriented organizational culture

Audit Department(5 persons)
- Conduct regular audits
- Investigate incidents and complaints and deal with them if and when necessary
- Provide feedback on employee awareness

Take the lead in establishing a "virtuous circle" of corporate achievements

Developing an ethical management system

KT&G is committed to open, honest, and transparent corporate governance. Our ethical management system comprises a complete set of ethical standards and guidelines and a Code of Ethics for executive managers that has been in place since 2001.

We put our ethical and transparent management policies into practice through an ethical management system. This includes a Business Ethics Charter, a Code of Ethics for our executive directors, a seven-part Compliance Program, and a Customer Service Code. In addition, we disclose all our relevant operational data on the Korea Exchange. As a result, we had not generated a single unfair trade case in 2008 and 2009.

Our Code of Ethics is subdivided into a number of operational areas, including our customers, the larger society, the environment, the marketplace, and our employees, business partners, and shareholders. Led by the Audit Office, we monitor how these policies are being carried out on a continuing basis. Our practices have been so successful that we were awarded the grand prize at the 4th Korea Ethical Management Awards in 2006.

KT&G insists on open, honest, and ethical behavior among all its employees. We encourage our business partners to improve their human rights, labor, anti-corruption, and environmental protection practices. Those that do are presented with a "Suppli-er-Quality Certification Manual."

Putting ethical management into practice

KT&G developed an online ethical management program and accompanying courses for use by its employees. The content of the courses is based on situations that could actually occur at an employee's worksite. The training has been targeted toward new hires since 2007.

In 2011, we took a number of steps to increase our employees' awareness of the importance of and need for honest, open, and ethical behavior. Examples of unacceptable and unethical behavior and related information were shared companywide, and employees were given training in ethical management issues as needed. In 2012, we conducted a study of the ethical management conditions at our major affiliates to ensure that everyone in the Group was singing from the same page.

Monitoring Our Ethical Management Programs

KT&G's Ethical Management Office conducts annual audits of each division, regional organization, branch, and office to check on their ethical management programs and processes. If instances of unacceptable and/or unethical behavior are uncovered, we make use of such measures as corrective orders, notifications, and recommendations for improvements. In more severe instances, such behavior can lead to an employee's dismissal, suspension, salary reduction, reprimand, or caution. At the opposite extreme, high performers are given prizes.

Creating Employee Value

Every competent business organization recognizes that its employees are its main agents for creating corporate value. At KT&G, we have implemented a "Human Resources Maximization Policy" to foster the development of leaders and experts who are able to live and work comfortably in any part of the world. We are also committed to ensuring that all our employees enjoy a proper balance between their work lives and their private lives. This goal is met in part by providing them with a wide range of employment benefits.

Human Resources Development

We foster the individual capabilities of all our employees by establishing an HR development mission, strategies and tasks that are aligned with our core values and the required attributes of our employees.

HRD Mission	Strengthen the competitiveness of our human resources by helping to develop the capabilities of each and every employee.
HR Goals and: Strategies	- Build a unidirectional organizational culture by internalizing the KT&G Way - Foster the development of future leaders to support change and innovation within the organization - Support training in problem-solving to ensure better performances - Provide solutions and content for both personal and group learning
Key Tasks:	**Unidirectional organizational culture** / **Foster leadership in change and innovation** / **Provide on-site training in problem-solving** / **Establish a learning support system**
	- Internalize the KT&G Way - Support the development of a performance- based organizational culture - Develop the capabilities of all our employees - Foster the development of future leaders - Carry out integrated customer marketing programs - Add to competencies of branch managers - Foster training and development of factory managers, both in Korea and overseas - Make improvements to e-learning programs - Establish an informal learning system

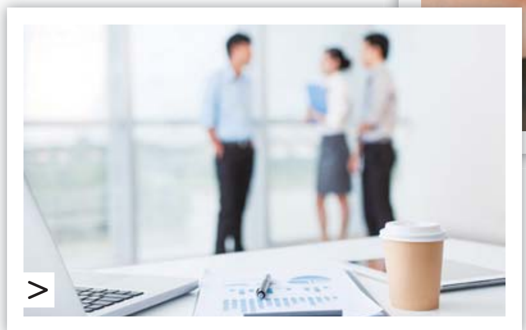
Training and Education

We finished building the KT&G Business Information Service in March 2011, enabling us to offer our employees a wide range of web- and smartphone-based video content and paper search services in the areas of the economy, management, and leadership. We also operate the KISS Education Management System. It assists our employees in keeping track of their educational history, managing the development of their careers, and sharing useful information with their peers.

Fair and Honest Evaluation System

All of our employees undergo a standardized job evaluation process. It measures the performances and analyzes the competencies of each employee, and rewards those who have posted outstanding performance results. All our new hires are paid 206% of the statutory minimum. After that, each employee is rewarded on the basis of his or her abilities.

Creating Employee Value



Hiring the Best People Possible

As per the requirements of the central government's Labor Standards Act, KT&G offers equal employment opportunities to all people, regardless of their place of birth, gender, or religion.

Employee benefits

KT&G provides all its workers with a wide range of employee benefits. They include a childcare allowance, payments for preschool, middle, and high school expenses, post-secondary school scholarships, congratulatory and condolence payments, housing loans, assistance with the cost of check-ups and other medical expenses, a host of recreational facilities, and a cafeteria plan. Other services are offered in consideration of an employee's age and years of service. We also operate an employee share ownership plan. In addition, all our workers are given the opportunity to develop their abilities through online training, vocational training, and E-MBA programs.

Leisure Time and Vacations

Employees who are on vacation can rest and relax in a number of KT&G accommodations, including condominiums, bed and breakfast establishments, and other facilities. After every five years of service, they can even take a vacation and enjoy a bonus. In addition, every employee who becomes pregnant is eligible for ninety days of maternity leave, while male workers are given three days off work upon the birth of a child. Employees with children aged six years or younger can take up to a one-year parental leave.

Retirement Pension Program

Our retirement pension program is designed to guarantee our workers' right to a retirement pension, and assist them in leading a stable life after they leave us. They have the option of choosing either a defined benefit or a defined contribution retirement plan.

Environmental Standards

Environmentally friendly management

KT&G's environmental management activities are designed to create harmony between its business activities and the needs of the environment. This includes managing for environmental risks and responding to climate change. Four of our factories have earned ISO 14001 environmental management system certifications. We also ranked first in the environmental, social, and governance evaluation by the Corporate Governance Service in 2011.

Environmental Management Strategies and Goals

KT&G has taken a number of steps to protect and preserve the environment and deal with climate change. They include strengthening our pollution emissions control systems and responding to the central government's low-carbon, green growth policies.

Establishing an environmental management system

KT&G has fewer environmental issues to deal with than many other businesses. Despite this, we have established a number of divisions that are charged with dealing with environment problems and issues at our manufacturing factories. In addition to monitoring our volume of energy savings and other environmentally-related issues, they measure the success of our eco-friendly factory operations and ensure that our pollution control systems are working properly. We have also established a Green Management Team that is tasked with carrying out our company-wide environmental management policies and processes. Much of its work involves reducing the level of greenhouse gas emissions at our factories.

KT&G Environmental Management Road Map

Environment management road map / Eco-friendly KT&G	Operate eco-friendly factories and facilities	Build pollution control systems	Enhance employees' awareness of the need to protect and preserve the environment.	Carry out external communications activities
Key activities	Operate eco-friendly processes in every factory and facility	Manage air, waste, and water pollution and the generation of greenhouse gases	Improve employee's awareness of the importance of preserving and protecting the environment through education and training	Enhance external communications capabilities
Road map of key mid- to long-term environmentally friendly tasks	- Obtain eco-friendly business designation - Increase rate of green purchases at worksites - Participate in exchanges with other progressive businesses - Create environmental teams and define their roles and responsibilities	- Evaluate environment management capabilities of suppliers - Raise employee's familiarity with environmental manual and ensure that they are following best practices - Manage greenhouse gas emissions to ensure that targets are met	- Add to employee's awareness of the need to preserve and protect the environment - Increase employees' level of training in environmental issues	- Carry out environmentally-related social contributions activities - Continue participating in Carbon Disclosure Project

Environmental Standards

Enhancing environmental management practices and policies

KT&G is committed to operating eco-friendly factories, minimizing the amount of pollutants that it generates, enhancing its employees' awareness of the need to protect and preserve the environment, and carrying out environmentally related social contributions activities. Making constant improvements to our environmentally friendly management system is one of our greatest priorities.

In addition to establishing an environmental management strategy and an accompanying road map, we have developed a wide range of implementation strategies to put them into practice. Our head office is in charge of general environmental management issues, while our worksites carry out specific tasks to reduce our environmental risks.

Carrying out environmentally friendly operations

Our annual investment in environmentally-related activities totaled more than KRW1,600 million since 2010. As a result, the amount of waste generated by our factories fell to 1.66 million tons in 2011 from 4.54 million tons in 2009—a 63% decrease. We have also taken a number of steps to reduce the amount of waste generated by our tobacco manufacturing processes, including reducing the volume of raw materials that we use. We are also adding to the quality of our products and increasing the amount of byproducts that we recycle.

Responding to climate change

Following the implementation of the central government's GHG and Energy Target Management System in 2012, many Korean companies have been required to accelerate their response to climate change. Even though KT&G is not one of those businesses, we are still committed to managing our energy consumption and our volume of greenhouse gas emissions, carrying out a wide range of activities to reduce both of them.

Lowering energy consumption and controlling GHG emissions

We calculate our total energy consumption at our five factories by classifying it into LNG and electricity, and are participating in the central government's green growth policy by measuring our level of greenhouse gas emissions. Our amounts of energy consumption and GHG emissions have been on the downturn thanks to our factory rationalization plan that was implemented in 2010. Our Yeongju factory signed an MOU on joint energy use with the nearby Novelis Korea factory in July 2011. Through this agreement, we capture and use about 2,700 tons of surplus steam generated by Novelis Korea. This will result in a reduction of 521 tons of CO2 a year. In recognition of this effort, the Yeongju factory received a "Best Energy-Saving Business in Gyeongbuk 2011" award.

Saving energy and reducing GHG emissions

We carry out a wide range of activities to reduce our energy consumption and GHG emissions levels at our worksites. Each factory is encouraged to use the most high-efficiency machinery and equipment possible and to sign energy-saving agreements with nearby businesses. Our GHG emissions reduction strategies include producing eco-friendly products and pushing for the integration of logistics among our Group companies.

Reducing energy consumption at our worksites

Although we are not classified as an industry group that consumes a lot of energy, we are carrying forward a broad range of activities to reduce our energy use on a company-wide manner. They include installing energy-saving equipment and participating in an energy service company project.

Integrating logistics among Group companies

We are committed to minimizing the amount of greenhouse gases that are generated during the transportation stage through the integrated operation of logistics among our Group companies. For example, we have been implementing an integrated operation of logistics with Korea Ginseng Corp. to create logistics synergy effects among our Group companies since the second half of 2012. This helps to reduce our transportation costs and adds to our efficiency.

Increasing the environmental performance of our products

We are constantly improving the quality of the materials used in the inside and outside packaging for our products to make them for environmentally friendly. This adds to their recyclability, lowers the amount of resources that we use, and reduces our level of GHG emissions.

Strengthening External Communications

We are increasing our investments in the environment sector to ensure that our factory operations do not cause complaints regarding odors, wastewater, or air pollution near our worksites. This includes investing about KRW2 billion to build an odor control facility near our Cheonan factory. We have also added to our wastewater treatment facilities and installed more dust collectors. In addition, we periodically organize environmental cleanup activities to strengthen our relationship with people living near our facilities.

We also operate tours of our factories in Yeongju, Gwangju, and Shintanjin. They help familiarize people with our manufacturing environment and our environmentally friendly facilities.

ISO 14001 Certifications

Shintanjin	Yeongju	Gwangju	Raw materials	Leaf processing
June 2005	June 2005	June 2005	December 2009	November 2008

* KT&G's environmental management activities include obtaining an ISO 14001 certification for all of its manufacturing factories.

Participation in Carbon Disclosure Project (CDP)

The goal of the Carbon Disclosure Project (CDP) is to tackle the problem of climate change. It is currently being carried out in more than sixty countries around the world. Since climate change issues are now emerging as an important factor guiding investment decisions, over 2,500 businesses around the world are disclosing their carbon management strategies and the volume of their GHG emissions through the CDP. This includes identifying risks and opportunities arising from climate change. KT&G has been participating in the CDP since 2010.

Corporate Social Responsibilities

Social Contribution Activities and the KT&G Way

KT&G has established the "KT&G Way" to coordinate its mid- to long-term social contributions activities. We are committed to supporting non-mainstream arts and culture in many different ways. Our employees share their talents by making the best of their strengths and abilities.

KT&G's Social Contributions Symbol

KT&G's social contribution symbol is a person holding a heart in the air. It symbolizes our hope for a happier and healthier future for everyone.

KT&G Way

Guidance for KT&G's mid-to long-term social contribution activities is provided by the "KT&G Way." In addition to continuing with our usual social contributions programs, we have expanded our interests to include Mecenat activities.

KT&G's Social Contributions Activities

KT&G's social contributions activities are based on the word "sangsang," or imagination. They are divided into five main areas: contributions to culture and the arts, helping the unprivileged, fostering the development of people with creative talents, sharing our abilities and strengths with other people, and activities that reflect the characteristics of the tobacco industry.

KT&G Way
- Sangsang Fund
- Volunteer work
- Positive feedback campaign

Scholarship Foundation
- Sangsang Scholarship Program
- Scholarships in pure science and other areas of study

Assistance to Culture and the Arts
- Sangsang Madang
- Sangsang Art Hall

Welfare Foundation
- Happiness Network Welfare Center
- Volunteer Center
- Internet-based welfare programs

CSR Activities
- Campaign to discourage young people from smoking
- Smoking etiquette campaign
- Projects to improve the smoking environment
- Support for medical research

Employee and Community Volunteer Groups

KT&G encourages voluntary employee participation and the development of a culture of caring and sharing through a wide range of community-based service activities. Employees at our worksites and branches visit social assistance facilities and carry out environmental activities through a network of 182 volunteer groups.

Sangsang Together: This employee voluntary service group helps people to deal with problems in their own communities.

Sangsang Volunteers: Sangsang Volunteers is a university student volunteer group consisting of about 7,000 members. Its members carry out volunteer activities that they have decided upon on their own, giving them a unique opportunity to fulfill themselves and make a real difference to people's lives.

Sangsang Univ.: Sangsang Univ. offers aspiring artists a venue for expressing their creativity. This results in the creation of a vibrant and exciting cultural and artistic community.

Sangsang Fund: KT&G created the "Sangsang Fund" in March 2011 to encourage the growth of a culture of caring and sharing. In addition to matching every employee's monetary donations, the company adds another KRW10,000 for every hour of their volunteer activities. Almost all of our employees are currently participating in this fund, donating KRW1,400 million on an annual basis. The fund is managed by a committee of employees, which decides on and carries out ideas that have been posted on the company's Intranet.

Sangsang Fund

KRW1.2 billion in 2011 → KRW2.4 billion in 2012 → KRW3.5 billion in 2013 (Estimated)

Social contribution investments

	2007	2008	2009	2010	2011	2012	Total
Social contribution investments	50.7	53.0	62.6	59.5	50.4	55.2	331.4

* Average KRW55.2 billion (in billions of KRW)

Mecenat Activities: Contributing to Culture and the Arts

KT&G is committed to assisting with the development of culture and the arts. Most of our programs are held at the Sangsang Madang and the Sangsang Art Hall. We joined the Korean Business Council for the Arts in 1994. In 2010, we were awarded a Cultural Contributions Award by it for our support of non-mainstream cultural and artistic endeavors.

Hongdae Sangsang Madang: This is a multiplex cultural space located in front of Hongik University. It supports non-mainstream cultural and artistic activities.

Nonsan Sangsang Madang: We opened this facility in the city of Nonsan in June 2011. Its goals are to expand cultural infrastructures within the local community, provide teenagers with a venue for creative and hands-on education, and assist up-and-coming writers.

Sangsang Art Hall: This professional theater space hosts a variety of plays, concerts, and musicals. Dedicated to the development of public performances in Korea, it introduces high-quality, popular works and supports new creative performances.

Activity Areas of Sangsang Madang

Performance: Incubating musical bands, Planning performances, Renting venue for performances	**Cinema:** Movie screenings, Planning and production, Distribution - CineLab
Visual Arts: Fine art exhibitions, Exhibitions of non-mainstream cultural and artistic works, Photography exhibitions, Support for photographers	**Design:** Exhibitions and distribution, Support for designers and mass production of their works
Academics: Training in culture and the arts for adults, Programs to develop people with talent in the areas of culture and the arts, Activities for teenagers, Lectures	**Communications:** Citizen participation programs, Events, Spatial tours, Community Familiarization Tours, Tour membership supporters

Corporate Social Responsibilities

KT&G Welfare Foundation: Supporting the Underprivileged

The KT&G Welfare Foundation engages in a variety of social assistance, healthcare, and other programs to realize "a tolerant society." We also support volunteer activities by teenagers, university students, and seniors. Our programs include assisting with disease treatment projects and operating eight Happiness Network Social Assistance Centers across the country.

Happiness Network Welfare Centers:
These centers offer professional services to people and communities that are in need of support and assistance. They do this by networking with local volunteer services.

Internet-Based Social Assistance Programs:
The KT&G Welfare Foundation engages in a variety of Internet-based social assistance programs. They include raising funds to help low-income families with their medical expenses through the Internet.

Social Assistance Support Programs:
The KT&G Welfare Foundation has been donating one hundred cars every year since 2004 for our "supporting sub-compact vehicles for social assistance centers" project to assist in the development of store-front social assistance centers. A total of six hundred cars have been donated to provide social workers with a fast and efficient means of transportation.

KT&G Scholarship Foundation: Fostering the development of future leaders

The KT&G Scholarship Foundation's scholarship and research assistance projects target talented young people from both Korea and abroad.

Sangsang Scholarship:
KT&G offers up to KRW4 million in yearly financial aid to students who come from low-income families, multicultural families, or the families of North Korean defectors. The assistance covers their school fees, private school fees, uniforms, and other expenses.

Scholarship for Graduate Students:
KT&G pays the entire amount of tuition for selected graduate students majoring in pure science at the Master's or PhD level. We do the same for Korean students who are studying overseas.

Report of Independent Auditors

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

We have audited the accompanying consolidated statements of financial position of KT&G Corporation (the "Company") and its subsidiaries (collectively the "Group") as of December 31, 2012, and the related consolidated statements of comprehensive income, changes in equity and cash flows for the year then ended, expressed in Korean won. 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. The consolidated financial statements of the Group as of and for the year ended December 31, 2011, presented herein for comparative purposes, were audited by other auditors whose report dated February 16, 2012, expressed an qualified opinion on those statements. The consolidated financial statements as of Dec 31, 2011, with unqualified opinion by KPMG Samjong Accounting Corporation do not reflect adjustments due to the change of accounting policy, stated in Note 2.1.1. However, the comparable consolidated financial statements on appendix reflect these adjustments.

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

In our opinion, the consolidated financial statements, referred to above, present fairly, in all material respects, the financial position of KT&G Corporation and its subsidiaries as of December 31, 2012, and their financial performance and cash flows for the year then ended, in accordance with International Financial Reporting Standards as adopted by the Republic of Korea ("Korean IFRS").

The accompanying consolidated financial statements as of and for the years ended December 31, 2012 and 2011, have been translated into US dollars solely for the convenience of the reader and have been translated on the basis set forth in Note 34 to the consolidated financial statements.

Auditing standards and their application in practice vary among countries. The procedures and practices used in the Republic of Korea to audit such financial statements may differ from those generally accepted and applied in other countries. Accordingly, this report is for use by those who are informed about Korean auditing standards and their application in practice.

Samil PricewaterhouseCoopers

Seoul, Korea
February 5, 2013

This report is effective as of February 5, 2013, 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 consolidated financial statements and notes thereto. Accordingly, the readers of the audit report should understand that there is a possibility that the above audit report may have to be revised to reflect the impact of such subsequent events or circumstances, if any.

Samil PricewaterhouseCoopers, LS Yongsan Tower, 191, Hangangno 2-ga, Yongsan-gu, Seoul 140-702, Korea (Yongsan P.O Box 266, 140-600), www.samil.com

KT&G Corporation and Subsidiaries
Consolidated Statements of Financial Position
December 31, 2012 and 2011

	Notes	December 31, 2012 Korean won	December 31, 2012 U.S. dollars (Note 34)	December 31, 2011 Korean won
Assets				
Non-current assets				
Property, factory and equipment	10,14	₩ 1,631,436	$ 1,523,141	₩ 1,584,346
Intangible assets	11	246,793	230,411	258,618
Investment property	12,14	181,986	169,905	188,351
Investments in associates	5,15	55,777	52,075	35,330
Available-for-sale financial assets	6,7	263,884	246,367	247,359
Other financial assets	6,17	275	256	1,427
Long-term deposits in MSA Escrow Fund	6,9,32	168,667	157,471	147,290
Long-term advance payments	32	144,649	135,047	142,880
Long-term prepaid expenses		5,416	5,056	5,775
Long-term trade and other receivables	6,8	121,784	113,700	134,115
Deferred income tax assets	28	17,491	16,330	15,487
		2,838,158	2,649,759	2,760,978
Current assets				
Inventories	16	1,706,796	1,593,498	1,572,299
Available-for-sale financial assets	6,7	1,000	934	1,044
Other financial assets	6,17	649,186	606,093	11,089
Prepaid tobacco excise and other taxes		257,183	240,111	201,911
Trade and other receivables	6,8	883,778	825,113	833,310
Advance payments	32	66,315	61,913	64,342
Prepaid expenses		20,523	19,160	20,516
Cash and cash equivalents	6,17	372,260	347,550	807,731
		3,957,041	3,694,372	3,512,242
Assets held for sale	5,13	762	711	3,196
Total assets		₩ 6,795,961	$ 6,344,842	₩ 6,276,416

(in millions of Korean won and thousands of U.S. dollars)

continued >>

	Notes	December 31, 2012 Korean won	December 31, 2012 U.S. dollars (Note 34)	December 31, 2011 Korean won
Equity				
Capital stock	1,18	₩ 954,959	$ 891,569	₩ 954,959
Other capital surplus	18	(4,573)	(4,269)	5,333
Treasury shares	19	(339,059)	(316,552)	(343,522)
Gain on reissuance of treasury shares	19	492,032	459,371	485,922
Reserve	20	3,011,110	2,811,230	2,663,313
Retained earnings	21	976,425	911,610	1,022,126
Equity attributable to equity holders of the Company		5,090,894	4,752,959	4,788,131
Non-controlling interests		103,524	96,652	96,946
Total equity		5,194,418	4,849,611	4,885,077
Liabilities				
Non-current liabilities				
Long-term borrowings	6,23	109,599	102,324	37,847
Long-term trade and other payables	6,22	25,407	23,721	26,031
Long-term advance receipts		20,239	18,895	14,072
Defined benefit liability	24	107,644	100,498	83,082
Provisions for other liabilities and charges		3,329	3,108	3,509
Deferred income tax liabilities	28	237,605	221,832	227,589
		503,823	470,378	392,130
Current liabilities				
Borrowings	6,23	91,868	85,770	82,836
Current portion of long-term borrowings	6,23	2,912	2,718	3,126
Trade and other payables	6,22	410,216	382,986	422,734
Advance receipts		30,875	28,826	12,628
Income taxes payable	28	148,925	139,039	164,579
Tobacco excise and other taxes payable		412,924	385,514	313,306
		1,097,720	1,024,853	999,209
Total liabilities		1,601,543	1,495,231	1,391,339
Total liabilities and equity		₩ 6,795,961	$ 6,344,842	₩ 6,276,416

(in millions of Korean won and thousands of U.S. dollars)

The accompanying notes are an integral part of these interim consolidated financial statements.

KT&G Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2012 and 2011

	Notes		2012 Korean won		2012 U.S. dollars (Note 34)		2011 Korean won
Sales		₩	3,984,662	$	3,720,159	₩	3,722,966
Cost of sales	26		(1,740,809)		(1,625,254)		(1,607,591)
Gross profit			2,243,853		2,094,905		2,115,375
Selling and administrative expenses	25,26		(1,207,922)		(1,127,740)		(1,025,034)
Operating income			1,035,931		967,165		1,090,341
Other income	25		75,101		70,116		118,899
Other expenses	25,26		(123,103)		(114,932)		(88,611)
Net other income			(48,003)		(44,816)		30,287
Finance income	27		43,000		40,146		47,339
Finance expense	27		(10,503)		(9,806)		(8,221)
Net Finance income			32,497		30,340		39,118
Income from jointly controlled entities and associates	15		2,223		2,075		1,326
Expense from jointly controlled entities and associates	15		(239)		(223)		(8)
Profit before income tax			1,022,409		954,541		1,161,064
Income tax expense	28		(297,291)		(277,557)		(344,135)
Profit for the year		₩	725,118	$	676,984	₩	816,929
Other comprehensive income							
Change in value of available-for-sale financial assets	7	₩	1,220	$	1,139	₩	(49,889)
Gain(Loss) on currency translation of foreign operations			(12,423)		(11,598)		(10,026)
Actuarial gain(loss) on defined benefit liability	24		(18,579)		(17,346)		(19,449)
Other comprehensive income (loss) for the year, net of tax			(29,781)		(27,805)		(79,364)
Total comprehensive income for the year		₩	695,337	$	649,179	₩	737,565
Profit for the year attributable to:							
Equity holders of the Parent Company		₩	738,037	$	689,046	₩	816,058
Non-controlling interests			(12,919)		(12,062)		871
		₩	725,118	$	676,984	₩	816,929
Total comprehensive income for the year attributable to:							
Equity holders of the Parent Company		₩	708,412	$	661,386	₩	737,799
Non-controlling interests			(13,075)		(12,207)		(234)
		₩	695,337	$	649,179	₩	737,565
Earnings per share attributable to the equity holders of the Parent Company during the year (in won)							
Basic and diluted earnings per share	29	₩	5,869	$	5.48	₩	6,451

(in millions of Korean won and thousands of U.S. dollars, except per share amounts)

The accompanying notes are an integral part of these interim consolidated financial statements.

KT&G Corporation and Subsidiaries

Consolidated Statements of Changes in Equity

Years Ended December 31, 2012 and 2011

		Attributable to equity holders of the Parent Company								
		Capital stock	Other Capital Surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained Earnings	Total	Non-controlling Interests	Total Equity
Balance at January 1, 2011	₩	954,959	5,333	(216,827)	482,129	2,179,227	1,151,359	4,556,180	42,130	4,598,310
Comprehensive income										
Profit for the year		-	-	-	-	-	816,058	816,058	871	816,929
Change in value of available-for-sale financial assets		-	-	-	-	(49,889)	-	(49,889)	-	(49,889)
Gain(Loss) on currency translation of foreign operations		-	-	-	-	(10,025)	-	(10,025)	-	(10,025)
Actuarial gain(loss) on defined benefit liability		-	-	-	-	-	(18,345)	(18,345)	(1,104)	(19,449)
Total comprehensive income (loss)		-	-	-	-	(59,914)	797,713	737,799	(233)	737,566
Transactions with equity holders of the Company										
Cash dividends		-	-	-	-	-	(382,946)	(382,946)	-	(382,946)
Other reserve		-	-	-	-	544,000	(544,000)	-	-	-
Disposition of treasury shares		-	-	2,976	3,793	-	-	6,769	-	6,769
Acquisition of treasury shares		-	-	(129,671)	-	-	-	(129,671)	-	(129,671)
Acquisition of investments in subsidiaries		-	-	-	-	-	-	-	55,049	55,049
Total transactions with equity holders of the Company		-	-	(126,695)	3,793	544,000	(926,946)	(505,848)	55,049	(450,799)
Balance at December 31, 2011	₩	954,959	5,333	(343,522)	485,922	2,663,313	1,022,126	4,788,131	96,946	4,885,077

(in millions of Korean won)

continued >>

KT&G Corporation and Subsidiaries
Consolidated Statements of Changes in Equity
Years Ended December 31, 2012 and 2011

		Attributable to equity holders of the Parent Company								
		Capital stock	Other Capital Surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained Earnings	Total	Non-controlling Interests	Total Equity
Balance at January 1, 2012	₩	954,959	5,333	(343,522)	485,922	2,663,313	1,022,126	4,788,131	96,946	4,885,077
Comprehensive income										
Profit for the year		-	-	-	-	-	738,037	738,037	(12,919)	725,118
Change in value of available-for-sale financial assets		-	-	-	-	1,220	-	1,220	-	1,220
Gain(Loss) on currency translation of foreign operations		-	-	-	-	(12,423)	-	(12,423)	-	(12,423)
Actuarial gain(loss) on defined benefit liability		-	-	-	-	-	(18,423)	(18,423)	(156)	(18,579)
Total comprehensive income (loss)		-	-	-	-	(11,203)	719,614	708,411	(13,075)	695,336
Transactions with equity holders of the Parent Company										
Cash dividends		-	-	-	-	-	(402,396)	(402,396)	-	(402,396)
Other reserve		-	-	-	-	359,000	(359,000)	-	-	-
Disposition of treasury shares		-	-	4,463	6,110	-	-	10,573	-	10,573
Convertible bond – equity component		-	-	-	-	-	-	-	5,390	5,390
Change in subsidiaries interest		-	(9,906)	-	-	-	-	(9,906)	9,834	(72)
Other transactions		-	-	-	-	-	(3,919)	(3,919)	4,429	510
Total transactions with equity holders of the Company		-	(9,906)	4,463	6,110	359,000	(765,315)	(405,648)	19,653	(385,995)
Balance at December 31, 2012	₩	954,959	(4,573)	(339,059)	492,032	3,011,110	976,425	5,090,894	103,524	5,194,418

(in millions of Korean won)

The accompanying notes are an integral part of these consolidated financial statements.

KT&G Corporation and Subsidiaries
Consolidated Statements of Changes in Equity
Year Ended December 31, 2012

		Attributable to equity holders of the Parent Company								
		Capital stock	Other Capital Surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained Earnings	Total	Non-controlling Interests	Total Equity
Balance at January 1, 2012	$	891,569	4,979	(320,719)	453,666	2,486,521	954,277	4,470,293	90,512	4,560,805
Comprehensive income										
Profit for the year		-	-	-	-	-	689,046	689,046	(12,062)	676,984
Change in value of available-for-sale financial assets		-	-	-	-	1,139	-	1,139	-	1,139
Gain(Loss) on currency translation of foreign operations		-	-	-	-	(11,598)	-	(11,598)	-	(11,598)
Actuarial gain(loss) on defined benefit liability		-	-	-	-	-	(17,201)	(17,201)	(145)	(17,346)
Total comprehensive income (loss)		-	-	-	-	(10,459)	671,845	661,386	(12,207)	649,179
Transactions with equity holders of the Parent Company										
Cash dividends		-	-	-	-	-	(375,685)	(375,685)	-	(375,685)
Other reserve		-	-	-	-	335,168	(335,169)	(1)	-	(1)
Disposition of treasury shares		-	-	4,167	5,705	-	-	9,872	-	9,872
Convertible bond – equity component		-	-	-	-	-	-	-	5,032	5,032
Change in subsidiaries interest		-	(9,248)	-	-	-	-	(9,248)	9,180	(68)
Other transactions		-	-	-	-	-	(3,658)	(3,658)	4,135	477
Total transactions with equity holders of the Company		-	(9,248)	4,167	5,705	335,168	(714,512)	(378,720)	18,347	(360,373)
Balance at December 31, 2012	$	891,569	(4,269)	(316,552)	459,371	2,811,230	911,610	4,752,959	96,652	4,849,611

(in thousands of U.S. dollars) (Note 34)

The accompanying notes are an integral part of these interim consolidated financial statements.

KT&G Corporation and Subsidiaries

Consolidated Statements of Cash Flows

Years Ended December 31, 2012 and 2011

	Notes		2012 Korean won		2012 U.S. dollars (Note 34)		2011 Korean won
Cash flows from operating activities							
Cash generated from operations	31	₩	1,026,914	$	958,747	₩	1,111,648
Income tax paid			(304,076)		(283,892)		(354,794)
Net cash generated from operating activities			722,838		674,855		756,854
Cash flows from investing activities							
Interest received			40,709		38,007		33,210
Investment income received from long-term deposits in MSA Escrow Fund			407		380		10,582
Dividends received			8,903		8,312		7,116
Proceeds from sale of property, factory and equipment			35,783		33,408		32,716
Proceeds from sale of intangible assets			830		775		25,473
Proceeds from sale of non-current asset held for sale			-		-		977
Proceeds from sale of available-for-sale financial assets			4,133		3,858		2,570
Proceeds from sale of investments in subsidiaries			-		-		113
Decrease in loans			21,612		20,177		21,972
Decrease in guarantee deposits			66,973		62,527		36,916
Acquisition of property, factory and equipment			(263,443)		(245,955)		(288,529)
Acquisition of intangible assets			(6,207)		(5,795)		(18,202)
Acquisition of investment property			(51)		(48)		(2,136)
Acquisition of jointly controlled entities and associates			(21,000)		(19,606)		(16,595)
Acquisition of investments in subsidiaries			-		-		(194,539)
Acquisition of available-for-sale financial assets			(16,500)		(15,405)		(22,316)
Increase in loans			(37,669)		(35,168)		(7,412)
Increase in guarantee deposits			(61,605)		(57,516)		(42,452)
Increase in long-term deposits in MSA Escrow Fund			(34,096)		(31,833)		(15,150)
Decrease(Increase) in other financial assets			(636,804)		(594,533)		7,069
Net cash used in investing activities			(898,025)		(838,415)		(428,617)
Cash flows from financing activities							
Interest paid			(11,557)		(10,790)		(3,563)
Dividends paid			(402,396)		(375,685)		(382,946)
Proceeds from borrowings			289,022		269,837		56,844
Increase in deposits received			5,903		5,511		10,135
Repayments of borrowings			(146,422)		(136,703)		(52,777)
Decrease in deposits received			(5,227)		(4,880)		(6,550)
Issuance of common stock			-		-		10
Disposition of treasury shares			12,525		11,694		7,980
Acquisition of treasury shares			-		-		(129,671)
Net cash used in financing activities			(258,152)		(241,016)		(500,538)
Net decrease in cash and cash equivalents			(433,339)		(404,576)		(172,301)
Cash and cash equivalents at the beginning of year			807,731		754,114		981,314
Exchange gains/(losses) on cash and cash equivalents			(2,132)		(1,988)		(1,282)
Cash and cash equivalents at the end of year		₩	372,260	$	347,550	₩	807,731

(in millions of Korean won and thousands of U.S. dollars)

The accompanying notes are an integral part of these interim consolidated financial statements.

KT&G Corporation and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 2012 and 2011

1. General Information

General information about KT&G Corporation (the "Parent Company") and its subsidiaries (collectively referred to "the Group") is as follows.

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

As of December 31, 2012, the Parent Company has two manufacturing factories, including the Shintanjin factory, and 14 local headquarters and 135 branches for the sale of tobacco throughout the country. Also, the Parent Company has the Gimcheon factory for fabrication of leaf tobacco and the Cheonan printing factory for the manufacturing of packaging. The head office of the Parent Company is located in Pyeongchon-dong, Daedeok-gu, Daejeon.

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

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

KT&G Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2012 and 2011

The ownership of the Parent Company's issued ordinary shares as of December 31, 2012, is held as follows:

Shareholders	Number of shares	Percentage of ownership
Industrial Bank of Korea	9,510,485	6.93%
Employee share ownership association	2,706,848	1.97%
Others	113,681,467	82.80%
	125,898,800	91.70%
Treasury shares	11,393,697	8.30%
	137,292,497	100.00%

The Parent Company's consolidated subsidiaries as of December 31, 2012, are as follows:

Immediate Parent	Subsidiaries	Location	Percentage of ownership (%)
			2012
KT&G Corporation	Korea Ginseng Corporation	Korea	100.00
	Yungjin Pharm. Ind. Co., Ltd.	Korea	53.00
	Tae-a Industry Co., Ltd.	Korea	100.00
	KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	99.99
	Korea Tabacos do Brasil Ltda.	Brazil	99.90
	KT&G Pars	Iran	99.99
	KT&G Rus L.L.C.	Russia	100.00
	KG Life & Gin Co., Ltd	Korea	100.00
	Global Trading, Inc.	USA	100.00
	Jilin Hanzheng Ginseng Co., Ltd.	China	100.00
	Somang Cosmetics Co., Ltd.[1]	Korea	60.00
	Renzoluc Pte., Ltd.[2]	Singapore	100.00
	KT&G Life Science[3]	Korea	73.94
	Yebon Nongwon Agriculture Co., Ltd	Korea	90.00
	KGC Yebon	Korea	100.00
	K-Q HongKong I,Limited[4]	Hong Kong	100.00
Renzoluc Pte., Ltd.	PT Trisakti Purwosari Makmur	Indonesia	60.17
PT Trisakti Purwosari Makmur	PT Sentosa Ababi Purwosari	Indonesia	99.24
	PT Purindo Ilufa	Indonesia	100.00
Korea Ginseng Corporation	Cheong Kwan Jang Taiwan Corporation	Taiwan	100.00
	Cheong Kwan Jang Taiwan Corporation	USA	100.00
	Korea Ginseng (China) Corp.	China	100.00
	Korea Ginseng Corporation Japan	Japan	100.00
	PT CKJ INDONESIA	Indonesia	99.88

[1] The Parent Company's percentage of ownership includes convertible preferred shares. As of December 31, 2012, the Company's percentage of ownership excludes convertible preferred shares, is 50.00%.

[2] The Parent Company's percentage of ownership includes convertible preferred shares. As of December 31, 2012, the Company's percentage of ownership excludes convertible preferred shares, is 68.91%.

[3] The Parent Company's percentage of ownership includes convertible preferred shares. As of December 31, 2012, the Company's percentage of ownership excludes convertible preferred shares, is 59.48%.

[4] The Parent Company's percentage of ownership includes convertible preferred shares. As of December 31, 2012, the Company's percentage of ownership excludes convertible preferred shares, is 50.00%.

KT&G Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2012 and 2011

Summarized financial information of subsidiaries as of December 31, 2012, is as follows:

Subsidiaries	Total assets	Total liabilities	Revenue	Profit (loss)	Total comprehensive income
Korea Ginseng Corporation	1,283,286	127,045	831,902	99,725	99,576
Yungjin Pharm. Ind. Co., Ltd.	161,951	70,882	137,688	1,794	1,189
Tae-a industry Co., Ltd.	14,868	3,418	16,221	355	278
KT&G Tutun Mamulleri Sanayive Ticaret A.S.	52,323	31,262	16,949	(5,697)	(5,613)
Korea Tabacos do Brasil Ltda.	1,099	11	-	-	-
KT&G Pars	43,136	43,008	20,749	(1,655)	(2,139)
KT&G Rus L.L.C.	142,108	37,580	44,363	(1,857)	(3,703)
KG Life & Gin Co., Ltd	21,441	12,494	57,008	(30,583)	(30,670)
Global Trading, Inc.	32,868	26,064	168,614	(7)	(529)
Jilin Hanzheng Ginseng Co., Ltd.	66,565	40,573	-	(3,637)	(5,265)
Somang Cosmetics Co., Ltd.	91,241	67,826	126,526	549	815
Renzoluc Pte., Ltd.	109,658	59,697	-	618	(2,236)
KT&G Life science	38,598	14,091	13	(6,170)	(6,083)
Yebon Nongwon Agriculture Co., Ltd	101	-	-	1	1
KGC Yebon	44,333	1,899	-	(1,267)	(1,267)
PT Trisakti Purwosari Makmur	133,652	91,383	51,422	(9,076)	(12,478)
Cheong Kwan Jang Taiwan Corporation	21,700	21,677	18,778	(1,775)	(1,777)
Korean Red Ginseng Corp., Inc.	6,587	3,404	10,319	86	(154)
Korea Ginseng (China) Corp.	43,714	34,149	33,780	(6,583)	(7,150)
Korea Ginseng Corporation Japan	5,536	3,551	6,315	(5,973)	(6,654)
K-Q HongKong I,Limited	34,396	-	-	398	(1,126)
PT CKJ INDONESIA	3,095	2,282	1,041	(40)	(67)

(in millions of Korean won)

During the year ended December 31, 2012, there has been no change in consolidation scope, except KGC Yebon, K-Q HongKong I,Limited and PT CKJ INDONESIA being included in the consolidation,while Rosee Cosmetics and KT&G Bio were liquidated.

KT&G Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2012 and 2011

2. Significant Accounting Policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the periods presented, unless otherwise stated.

2.1 Basis of Preparation

The Group maintains its accounting records in Korean won and prepares statutory financial statements in the Korean language (Hangul) in accordance with the International Financial Reporting Standards as adopted by the Republic of Korea ("Korean IFRS"). The accompanying consolidated financial statements have been condensed, restructured and translated into English from the Korean language financial statements.

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

The Group's financial statements for the annual period beginning on January 1, 2011, have been prepared in accordance with Korean IFRS. These are the standards, subsequent amendments and related interpretations issued by the International Accounting Standards Board ("IASB") that have been adopted by the Republic of Korea.

The preparation of the consolidated financial statements requires the use of certain critical accounting estimates. It also requires management to exercise judgment in the process of applying the Group's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 3.

2.1.1 Changes in Accounting Policy and Disclosures

(a) New and amended standards adopted by the Group

The Group changed its accounting policy to present the operating income after deducting cost of sales, and selling and administrative expenses from revenue, in accordance with the amendment of Korean IFRS 1001, *Presentation of Financial Statements*.

The Group applies the accounting policy retroactively in accordance with the amended standards and the comparative consolidated statement of the comprehensive income is restated by reflecting adjustments resulting from the retrospective application. As a result of the changes in the accounting policy, other income and expenses of ₩75,101 million and ₩123,103 million, respectively, for the year ended December 31, 2012 (2011: ₩118,899 million and ₩88,611 million, respectively), which include gain or loss on disposal of property, factory and equipment, gain on valuation of available-for-sale securities and gain or loss on disposal of investments in associates and others, classified as operating income under the previous standard, were excluded from operating income. Consequently, operating income for the years ended December 31, 2012 and 2011, increased by ₩48,002 million and decreased by ₩30,288 million, respectively, as compared to the amounts under the previous standard. However, there is no material impact on net income and earnings per share for the years ended December 31, 2012 and 2011.

(b) New standards and interpretations not yet adopted

New standards, amendments and interpretations issued but not effective for the financial year beginning January 1, 2012, and not early adopted by the Group are as follows:

KT&G Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2012 and 2011

- Amendment of Korean IFRS 1001, *Presentation of Financial Statements*

  Korean-IFRS 1001, Presentation of Financial Statements, was amended to require other comprehensive income items to be presented into two groups on the basis of whether they are potentially reclassifiable to profit or loss subsequently. This is effective for annual periods beginning on or after July 1, 2012, with early adoption permitted. The Group expects that the application of this amendment would not have a material impact on its consolidated financial statements.

- Amendments to Korean IFRS 1019, *Employee Benefits*

  According to the amendments to Korean IFRS 1019, Employee Benefits, the use of a 'corridor' approach is no longer permitted, and therefore all actuarial gains and losses incurred are immediately recognized in other comprehensive income. All past service costs incurred from changes in pension plan are immediately recognized, and expected returns on interest costs and plan assets that used to be separately calculated are now changed to calculating net interest expense (income) by applying discount rate used in measuring defined benefit obligation in net defined benefit liabilities (assets). This amendment will be effective for annual periods beginning on or after January 1, 2013, and the Group is assessing the impact of application of the amended Korean IFRS 1019 on its consolidated financial statements as of the report date.

- Enactment of Korean IFRS 1113, *Fair Value Measurement*

  Korean IFRS 1113, Fair value measurement, aims to improve consistency and reduce complexity by providing a precise definition of fair value and a single source of fair value measurement and disclosure requirements for use across Korean IFRSs. Korean IFRS 1113 does not extend the use of fair value accounting but provides guidance on how it should be applied where its use is already required or permitted by other standards within the Korean IFRSs. This amendment will be effective for annual periods beginning on or after January 1, 2013, and the Group expects that the application of this enactment would not have a material impact on its consolidated financial statements.

- Enactment of Korean IFRS 1110, *Consolidated Financial Statements*

  Korean IFRS 1110, Consolidated Financial Statements, builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included in the consolidated financial statements of the Parent Company. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. The standard provides additional guidance to assist in the determination of control where this is difficult to assess. This amendment will be effective for annual periods beginning on or after January 1, 2013, and the Group is reviewing the impact of the amended Korean IFRS 1110.

- Enactment of Korean IFRS 1111, *Joint Arrangements*

  Korean IFRS 1111, Joint Arrangements, aims to reflect the substance of joint arrangements by focusing on the contractual rights and obligations that each party to the arrangement has rather than its legal form. Joint arrangements are classified as either joint operations or joint ventures. A joint operation is when joint operators have rights to the assets and obligations for the liabilities, and account for the assets, liabilities, revenues and expenses, while parties to the joint venture have rights to the net assets of the arrangement and account for their interest in the joint venture using the equity method. This amendment will be effective for annual periods beginning on or after January 1, 2013, and the Group is reviewing the impact of the amended Korean IFRS 1111.

- Enactment of Korean IFRS 1112, *Disclosures of Interests in Other Entities*

  Korean IFRS 1112, Disclosures of Interests in Other Entities, provides the disclosure requirements for all forms of interests in other entities, including a subsidiary, a joint arrangement, an associate, a consolidated structured entity and an unconsolidated structured entity. This amendment will be effective for annual periods beginning on or after January 1, 2013, and the Group is reviewing the impact of the amended Korean IFRS 1112.

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2.2 Consolidation

The Group has prepared the consolidated financial statements in accordance with Korean-IFRS1027, *Consolidated and Separate Financial Statements*.

(a) Subsidiaries

Subsidiaries are all entities (including special purpose entities) over which the Parent Company has the power to govern the financial and operating policies generally accompanying a shareholding of more than one-half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Parent Company controls another entity. The Group also assesses existence of control where it does not have more than 50% of the voting power but is able to govern the financial and operating policies by virtue of de-facto control. De-facto control may arise in circumstances where the size of the Group's voting rights relative to the size and dispersion of holdings of other shareholders give the Group the power to govern the financial and operating policies and others.

Subsidiaries are fully consolidated from the date on which control is transferred to the Parent Company. They are de-consolidated from the date that control ceases.

The Group applies the acquisition method to account for business combinations. The consideration transferred for the acquisition of a subsidiary is measured as the fair values of the assets transferred, the liabilities incurred to the former owners of the acquiree and the equity interests issued by the Company. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The Group recognizes any non-controlling interest in the acquiree on an acquisition- by-acquisition basis, either at fair value or at the non-controlling interest's proportionate share of the recognized amounts of acquiree's identifiable net assets.

Acquisition-related costs are expensed as incurred.

If the business combination is achieved in stages, the acquisition date fair value of the acquirer's previously held equity interest in the acquiree is remeasured to fair value at the acquisition date and the resulting gain or loss is recognized in profit or loss.

Any contingent consideration to be transferred by the Group is recognized at fair value at the acquisition date. Subsequent changes to the fair value of the contingent consideration that is deemed to be an asset or liability is recognized in accordance with Korean-IFRS1039, either in profit or loss or as a change to other comprehensive income. Contingent consideration that is classified as equity is not remeasured, and its subsequent settlement is accounted for within equity.

Goodwill is initially measured as the excess of the aggregate of the consideration transferred and the fair value of non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognized in profit or loss.

Intercompany transactions, balances, income and expenses on transactions between Group companies are eliminated. Unrealized losses are also eliminated after recognizing impairment of transferred assets. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

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(b) Associates

Associates are all entities over which the Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method of accounting. Under the equity method, the investment is initially recognized at cost, and the carrying amount is increased or decreased to recognize the investor's share of the profit or loss of the investee after the date of acquisition. The Group's investment in associates includes goodwill identified on acquisition, net of any accumulated impairment loss.

If the ownership interest in an associate is reduced but significant influence is retained, only a proportionate share of the amounts previously recognized in other comprehensive income is reclassified to profit or loss where appropriate.

The Group's share of post-acquisition profit or loss is recognized in the statement of comprehensive income, and its share of post-acquisition movements in other comprehensive income is recognized in other comprehensive income with a corresponding adjustment to the carrying amount of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the Group does not recognize further losses, unless it has incurred legal or constructive obligations or made payments on behalf of the associate.

The Group determines at each reporting date whether there is any objective evidence that the investment in the associate is impaired. If this is the case, the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying value and recognizes the amount as 'impairment loss on investment in an associate' in the statement of comprehensive income.

Unrealized gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates. Unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of associates have been changed where necessary to ensure consistency with the policies adopted by the Group. Dilution gains and losses arising in investments in associates are recognized in the statement of comprehensive income.

(c) Joint ventures

A joint venture is a contractual arrangement whereby two or more parties (venturers) exercise joint control.

As with associates, investments in jointly controlled entities are accounted for using the equity method of accounting and are initially recognized at cost. The Group's investment in jointly controlled entities includes goodwill identified on acquisition, net of accumulated impairment loss. The Group does not recognize its share of profits or losses from the joint venture that result from the Group's purchase of assets from the joint venture until it re-sells the assets to an independent party.

However, a loss on the transaction is recognized immediately if the loss provides evidence of a reduction in the net realizable value of current assets, or an impairment loss.

(d) Changes in ownership interests in subsidiaries without change of control

Transactions with non-controlling interests that do not result in loss of control are accounted for as equity transactions; that is, as transactions with the owners in their capacity as owners.

The difference between fair value of any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary is recorded in equity. Gains or losses on disposals to non-controlling interests are also recorded in equity.

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2.3 Segment Reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker (Note 5). The chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the steering committee that makes strategic decisions.

2.4 Foreign Currency Translation

(a) Functional and presentation currency

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated financial statements are presented in Korean won, which is the controlling entity's functional and presentation currency.

(b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions or valuation where items are re-measured. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in the statement of comprehensive income, except when deferred in other comprehensive income as qualifying cash flow hedges and qualifying net investment hedges.

Foreign exchange gains and losses that relate to borrowings and cash and cash equivalents are presented in the statement of comprehensive income within 'financial income or expenses'. All other foreign exchange gains and losses are presented in the statement of comprehensive income within 'other gains and losses, net'.

Changes in the fair value of monetary securities denominated in foreign currency classified as available-for-sale are analyzed between translation differences resulting from changes in the amortized cost of the security and other changes in the carrying amount of the security. Translation differences related to changes in amortized cost are recognized in profit or loss, and other changes in carrying amount are recognized in other comprehensive income.

(c) Translation to presentation currency

The results and financial position of all Group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- assets and liabilities for each statement of financial position presented are translated at the closing rate at the end of the reporting period;
- income and expenses for each statement of comprehensive income are translated at average exchange rates; and
- all resulting exchange differences are recognized in other comprehensive income.

Exchange differences arising from the translation of borrowings designated for hedging the investment and other currency instruments are recognized in other comprehensive income. When foreign operations are wholly or partially sold, exchange differences recognized in equity are transferred to profit or loss in the statement of comprehensive income. When the Company ceases to control the subsidiary, exchange differences that were recorded in equity are recognized in the statement of comprehensive income as part of the gain or loss on sale.

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Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

2.5 Cash and Cash Equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less.

2.6 Financial Assets

2.6.1 Classification

The Group classifies its financial assets in the following categories: at fair value through profit or loss, loans and receivables, available-for-sale, and held-to-maturity. The classification depends on the purpose for which the financial assets were acquired. Management determines the classification of its financial assets at initial recognition.

(a) Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss are financial assets held for trading. A financial asset is classified in this category if acquired principally for the purpose of selling in the short term. Derivatives or embedded derivatives are also categorized as held for trading unless they are designated as hedges. Assets in this category are classified as current assets.

(b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are included in current assets, except for maturities greater than 12 months after the end of the reporting period. These are classified as non-current assets. The Group's loans and receivables comprise 'cash and cash equivalents', 'trade and other receivables', and 'other financial assets' in the statement of financial position.

(c) Available-for-sale financial assets

Available-for-sale financial assets are non-derivatives that are either designated in this category or not classified in any of the other categories. They are included in non-current assets unless the investment matures or management intends to dispose of them within 12 months after the end of the reporting period.

(d) Financial liabilities carried at amortized cost

The Group classifies non-derivative financial liabilities, except for financial liabilities at fair value through profit or loss, financial guarantee contracts and financial assets that arise when a transfer of financial liabilities at fair value through profit or loss, financial guarantee contracts and financial assets does not qualify for derecognition, as financial liabilities carried at amortized cost. In case when a transfer of a financial asset does not qualify for derecognition, the transferred asset is continuously recognized as asset and the consideration received is recognized as financial liabilities. Financial liabilities carried at amortized cost are included in non-current liabilities, except for liabilities with maturities within 12 months after the end of the reporting period, which are classified as current liabilities.

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2.6.2 Recognition and Measurement

Regular purchases and sales of financial assets are recognized on the trade date. Investments are initially recognized at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss. Financial assets carried at fair value through profit or loss are initially recognized at fair value, and transaction costs are expensed in the statement of comprehensive income. Financial assets are derecognized when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership. Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Loans and receivables are subsequently carried at amortized cost using the effective interest rate method.

Gains or losses arising from changes in the fair value of the financial assets carried at fair value through profit or loss are presented in the statement of comprehensive income within 'other gains and losses, net' in the period in which they arise. Dividend income from financial assets at fair value through profit or loss is recognized in the statement of comprehensive income as part of 'other income' when the Group's right to receive dividend payments is established.

When securities classified as available-for-sale are sold or impaired, the accumulated fair value adjustments recognized in equity are included in the statement of comprehensive income as 'financial gains and losses, net'.

Interest on available-for-sale and held-to-maturity securities calculated using the effective interest method is recognized in the statement of comprehensive income as part of 'financial income'. Dividends on available-for-sale equity instruments are recognized in the statement of comprehensive income as part of 'financial income' when the Group's right to receive dividend payments is established.

2.6.3 Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis or realize the asset and settle the liability simultaneously.

2.7 Impairment of Financial Assets

(a) Assets carried at amortized cost

The Group assesses at the end of each reporting period whether there is objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or a group of financial assets that can be reliably estimated.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss include:

- Significant financial difficulty of the issuer or obligor;
- Delinquency in interest or principal payments for more than three months;
- For economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- It becomes probable that the borrower will enter bankruptcy or other financial reorganization;
- The disappearance of an active market for that financial asset because of financial difficulties; or

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- Observable data suggesting that there is a measurable decrease in the estimated future cash flows from a portfolio of financial assets since the initial recognition of those assets, even though the decrease cannot be identified with respect to individual financial assets in the portfolio, such as:
  - (i) adverse changes in the payment status of borrowers in the portfolio;
  - (ii) national or local economic conditions that correlate with defaults on the assets in the portfolio.

Impairment loss is measured as the difference between the assets' carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted using the initial effective interest rate. The carrying amount of the asset is reduced by the impairment loss amount and the amount of the loss is recognized in the statement of comprehensive income. In practice, the Group may measure impairment loss based on the fair value of financial asset using an observable market price.

If, in a subsequent period, the amount of impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (for example, an improvement in debtor's credit rating), the reversal of the previously recognized impairment loss is recognized in the statement of comprehensive income.

(b) Assets classified as available-for-sale

The Group assesses at the end of each reporting period whether there is objective evidence that a financial asset or a group of financial assets is impaired. For debt securities, the Group uses the criteria refer to in (a) above. In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost, for example decrease in fair value of the investments by more than 30% from its cost for more than six months, is also evidence that the asset is impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognized in profit or loss – is removed from equity and recognized in the statement of comprehensive income. Impairment losses recognized in the consolidated statement of comprehensive income on equity instruments are not reversed through the statement of comprehensive income. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in profit or loss, the impairment loss is reversed through the statement of comprehensive income.

2.8 Trade Receivables

Trade receivables are amounts due from customers for merchandise sold or services performed in the ordinary course of business. If collection is expected in one year or less, they are classified as current assets. If not, they are presented as non-current assets. Trade receivables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less allowance for doubtful accounts.

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2.9 Inventories

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

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

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

Tobacco leaf inventories which have an operating cycle that exceeds 12 months are classified as current assets, consistent with recognized industry practice. The estimated amounts of inventories in current assets which are not expected to be realized within 12 months are ₩347,489 million and ₩385,459 million as of December 31, 2012 and 2011, respectively.

2.10 Non-current Assets (or disposal group) Held for Sale

Non-current assets (or disposal group) are classified as assets held for sale when their carrying amount is to be recovered principally through a sale transaction and a sale is considered highly probable. They are stated at the lower of carrying amount and fair value less costs to sell.

2.11 Property, Factory and Equipment

All property, factory and equipment are stated at historical cost less depreciation and accumulated impairment loss. Historical cost includes expenditures directly attribute to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. All other repairs and maintenance are charged to the statement of comprehensive income during the financial period in which they are incurred.

Land is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between their cost and their residual values over their estimated useful lives, as follows:

Buildings	10 - 60 years
Structures	4 - 40 years
Machinery	2 - 20 years
Vehicle	4 - 5 years
Tools and equipment	4 - 5 years
Supplies	4 - 5 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated

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recoverable amount. Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized within 'other income and expenses, net' in the statement of comprehensive income.

2.12 Borrowing Costs

General and specific borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale. Investment income earned on the temporary investment of specific borrowings pending their expenditure on qualifying assets is deducted from the borrowing costs eligible for capitalization. All other borrowing costs are recognized in profit or loss in the period in which they are incurred.

2.13 Government Grants

Grants from a government are recognized at their fair value where there is a reasonable assurance that the grant will be received and the Group will comply with all attached conditions.

Government grants relating to property, factory and equipment are presented as a deduction of related assets and are credited to depreciation over the expected lives of the related assets.

Government grants relating to costs are deferred and recognized in the statement of comprehensive income over the period necessary to match them with the costs that they are intended to compensate.

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2.14 Intangible Assets

(a) Goodwill

Goodwill is measured as explained in Note 2.2(1) and goodwill arises on the acquisition of subsidiaries, associates and business are included in intangible assets. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the CGUs, or group of CGUs, that is expected to benefit from the synergies of the combination. Goodwill is monitored at the operating segment level.

Goodwill impairment reviews are undertaken annually or more frequently if events or changes in circumstances indicate a potential impairment. The carrying value of goodwill is compared to the recoverable amount, which is the higher of value in use and the fair value less costs to sell. Any impairment is recognized immediately as an expense and is not subsequently reversed.

(b) Other intangible assets

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

The estimated useful lives are as follows:

Industrial property rights	10 - 20 years or indefinite
Facility usage rights	Indefinite
Other intangible assets	4 - 15 years or indefinite

Amortization periods and amortization methods for intangible assets with finite useful lives are reviewed at the end of each reporting period. The useful lives of intangible assets that are not being amortized are reviewed at the end of each reporting period to determine whether events and circumstances continue to support indefinite useful life assessment for those assets.
The change is accounted for as a change in an accounting.

2.15 Investment Property

Investment property is held to earn rentals or for capital appreciation or both. Investment property also includes property that is being constructed or developed for future use as investment property. Investment property is measured initially at its cost including transaction costs incurred in acquiring the asset. After recognition as an asset, investment property is carried at cost less accumulated depreciation and impairment losses.

Subsequent costs are include in the asset's carrying amount or recognized as a separate asset, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. All other repairs and maintenance are charged to the statement of comprehensive income during the financial period in which they are incurred.

Land held for investment is not depreciated. Investment property, except for land, is depreciated using straight-line method over their useful lives from ten to 60 years.

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The depreciation method, the residual value and the useful life of an asset are reviewed at the end of each financial year and, if management judges that previous estimates should be adjusted, the change is accounted for as a change in an accounting estimate.

2.16 Impairment of Non-financial Assets

Goodwill or intangible assets with indefinite useful lives are not subject to amortization and are tested annually for impairment. Assets that are subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Non-financial assets, other than goodwill, that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

2.17 Trade Payables

Trade payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Trade payables are classified as current liabilities if payment is due within one year or less. If not, they are presented as non-current liabilities. Trade payables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method.

2.18 Borrowings

Borrowings are recognized initially at fair value, net of transaction costs incurred. Borrowings are subsequently carried at amortized cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognized in the statement of comprehensive income over the period of the borrowings using the effective interest method. The Group recognizes borrowings as current assets unless it has an unconditional right to delay the settlement of the borrowing. Preference shares, which are mandatorily redeemable on a specific date, are classified as liabilities. The dividends on these preference shares are recognized in the statement of comprehensive income as 'finance expense'.

2.19 Compound Financial Instruments

Compound financial instruments issued by the Group comprise convertible notes that can be converted to share capital at the option of the holder, and the number of shares to be issued does not vary with changes in their fair value.

The liability component of a compound financial instrument is recognized initially at the fair value of a similar liability that does not have an equity conversion option. The equity component is recognized initially at the difference between the fair value of the compound financial instrument as a whole and the fair value of the liability component. Any directly attributable transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts.

Subsequent to initial recognition, the liability component of a compound financial instrument is measured at amortized cost using the effective interest method. The equity component of a compound financial instrument is not re-measured subsequent to initial recognition except on conversion or expiry.

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2.20 Provisions

Provisions are recognized when: the Group has a present legal or constructive obligation as a result of past events; it is probable that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated. Provisions are not recognized for future operating losses.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to passage of time is recognized as interest expense.

2.21 Current and Deferred Income Tax

The tax expense for the period comprises current and deferred tax. Tax is recognized in the statement of comprehensive income, except to the extent that it relates to items recognized in other comprehensive income or directly in equity. In this case, the tax is also recognized in other comprehensive income or directly in equity.
The current income tax charge is calculated on the basis of the tax laws enacted or substantively enacted at the statement of financial position date in the countries where the Group operates and generates taxable income. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. It establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred income tax is recognized, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax assets and liabilities are not recognized if they arise from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates and laws that have been enacted or substantially enacted by the statement of financial position date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except for deferred income tax liability where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes assets and liabilities relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities where there is an intention to settle the balances on a net basis.

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2.22 Employee Benefits

(a) Defined benefit liability

Group companies operate various pension schemes. The schemes are generally funded through payments to insurance companies or trustee-administered funds, determined by periodic actuarial calculations. The Group has both defined benefit and defined contribution plans.

A defined contribution plan is a pension plan under which the Group pays fixed contributions into a separate entity. The Group has no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods. For defined contribution plans, the Group pays contributions to publicly or privately administered pension insurance plans on a mandatory, contractual or voluntary basis. The Group has no further payment obligations once the contributions have been paid. The contributions are recognized as employee benefit expense when they are due. Prepaid contributions are recognized as an asset to the extent that a cash refund or a reduction in the future payments is available.

A defined benefit plan is a pension plan that is not a defined contribution plan. Typically defined benefit plans define an amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and compensation. The liability recognized in the statement of financial position in respect of defined benefit pension plans is the present value of the defined benefit obligation at the end of the reporting period less the fair value of plan assets, together with adjustments for unrecognized past-service costs. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension obligation.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to equity in other comprehensive income in the period in which they arise. Past-service costs are recognized immediately in income, while costs are amortized over the vesting period.

(b) Termination benefits

Termination benefits are payable when employment is terminated by the Group before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Group recognizes termination benefits when it is demonstrably committed to a termination when the entity has a detailed formal plan to terminate the employment of current employees without possibility of withdrawal and in the case of an offer made to encourage voluntary redundancy.

2.23 Share Capital

Where the Parent Company purchases its own equity share capital (treasury shares), the consideration paid, including any directly attributable incremental costs is deducted from equity attributable to the Company's equity holders until the shares are cancelled or reissued. Where such ordinary shares are subsequently reissued, any consideration received is included in equity attributable to the Company's equity holders.

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2.24 Revenue Recognition

The Group's revenue categories consist of goods sold, services and other income. Revenue from sale of goods is measured at the fair value of the consideration received or receivable, net of tobacco excise and other taxes, trade discounts and volume rebates. Revenue from the sale of goods is recognized when the Group has transferred to the buyer the significant risks and rewards of ownership of the goods, the Group retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Group and the costs incurred or to be incurred in respect of the transaction can be measured reliably. Tobacco excise and other taxes deducted from revenue for the years ended December 31, 2012 and 2011, were ₩3,662,085 million and ₩3,462,687 million, respectively.

Revenue from the construction of real estate includes the initial amount agreed in the contract plus any variations in contract work, claims and incentive payments, to the extent that it is probable that they will result in revenue and can be measured reliably. As soon as the outcome of a construction contract can be estimated reliably, contract revenue is recognized in profit or loss in proportion to the stage of completion of the contract. The stage of completion is assessed by reference to surveys of work performed. Meanwhile, profits from an apartment house for self-installment sales is recognized on percentage-of-completion method according to Q&A of Korea Accounting Institute, called 2011-I-KQA. This accounting standard is effective upon Korean Corporation Financial Reporting Standards of Laws on External Audit of Corporation (Article 13, Section 1, Paragraph 1)

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

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

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

2.25 Lease

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the statement of income on a straight-line basis over the period of the lease.

2.26 Dividend Distribution

Dividend distribution to the Parent Company's shareholders is recognized as a liability in the financial statements in the period in which the dividends are approved by the Parent Company's shareholders.

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2.27 Approval of Issuance of the Financial Statements

The issuance of the December 31, 2012 financial statements of the Company was approved by the Board of Directors on January 17, 2013.

3. Critical Accounting Estimates and Judgments

The management makes judgments, estimates and assumptions that affects the application of accounting policies and the amounts of reported assets and liabilities and profits and costs in the preparation of the financial statements. Estimations and assumptions are continuously evaluated with consideration to factors such as events reasonably predictable in the foreseeable future within the present circumstance according to historical experience. The resulting accounting estimates will, by definition, seldom equal the related actual results.

(a) Estimated impairment of goodwill

The Group tests annually whether goodwill has suffered any impairment in accordance with the accounting policy stated in Note 2.16. The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates.

(b) Income taxes

The Group is operating in numerous countries and the income generated from these operations is subject to income taxes based on tax laws and interpretations of tax authorities in numerous jurisdictions. There are many transactions and calculations for which the ultimate tax determination is uncertain. The Group recorded, based on its best estimate, current taxes and deferred taxes that the Group will be liable in the future for the operating results as of the financial year end. However, the final tax outcome in the future may be different from the amounts that were initially recorded. Such differences will impact the current and deferred income tax assets and liabilities in the period in which such determination is made.

(c) Fair value of financial instruments

The fair value of financial instruments that are not traded in an active market is determined by using valuation techniques. The Group uses its judgment to select a variety of methods and make assumptions that are mainly based on market conditions existing at the end of each reporting period.

(d) Defined benefit liability

The present value of the defined benefit liability depends on a number of factors that are determined on an actuarial basis using a number of assumptions. The assumptions used in determining the net cost (income) for pensions include the discount rate. Any changes in these assumptions will impact the carrying amount of the defined benefit liability. The Group determines the appropriate discount rate at the end of each year. This is the interest rate that is used to determine the present value of estimated future cash outflows expected to be required to settle the defined benefit liability. In determining the appropriate discount rate, the Group considers the interest rates of high-quality corporate bonds that are denominated in the currency in which the pension benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. Other key assumptions for defined benefit liability are based in part on current market conditions. Additional information is disclosed in Note 24.

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4. Financial Risk Management

4.1 Financial Risk Factors

The Group's activities expose it to a variety of financial risks: market risk (including currency risk, fair value interest rate risk, cash flow interest rate risk and price risk), credit risk and liquidity risk. The Company's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the Company's financial performance.

The Company uses derivative financial instruments to hedge certain risk exposures.
Risk management is carried out by a central treasury department (Group treasury) under policies approved by the board of directors. The Group treasury identifies, evaluates and hedges financial risks in close co-operation with the Group's operating units. The board provides written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non-derivative financial instruments, and investment of excess liquidity.

(a) Market risk

i) Foreign exchange risk

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

The carrying amounts of monetary assets and liabilities denominated in a currency other than the functional currency as of December 31, 2012 and 2011, are as follows:

		2012			2011		
		USD	EUR	JPY	USD	EUR	JPY
Assets							
Cash and cash equivalents	₩	19,284	5	9	26,121	68	1,471
Trade and other receivables		493,243	3,256	6,410	431,592	17,078	3,560
Long-term deposits		168,667	-	-	147,290	-	-
	₩	681,194	3,261	6,419	605,003	17,146	5,031
Liabilities							
Trade and other payables	₩	16,544	3,153	2,129	41,997	4,491	54,559
Short-term borrowings		1,406	-	-	-	-	-
	₩	17,950	3,153	2,129	41,997	4,491	54,559

(in millions of Korean won)

As of December 31, 2012 and 2011, the effects of a 10% strengthening or weakening of functional currency against the US dollar other than functional currency on profit before tax were as follows:

		2012		2011	
		10% strengthening	10% weakening	10% strengthening	10% weakening
US dollar	₩	66,324	(66,324)	56,301	(56,301)

(in millions of Korean won)

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ii) Price risk

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

As of December 31, 2012 and 2011, the effects of a 5% fluctuation of the price index of stocks on other comprehensive income are as follows:

		2012		2011	
		5% increase	5% decrease	5% increase	5% decrease
Other comprehensive income before tax	₩	5,266	(5,266)	8,464	(8,464)
Tax effect		(1,274)	1,274	(2,048)	2,048
Other comprehensive income after tax	₩	3,992	(3,992)	6,416	(6,416)

(in millions of Korean won)

iii) Interest rate risk

The Group has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Group's management has monitored the level of interest rates regularly and has maintained the balance of borrowings at variable rates and fixed rates. As of December 31, 2012 and 2011, the amount of borrowings issued at variable rates is ₩53,459 million and ₩27,840 million, respectively. There is no significant effect on cash flows or the fair value of financial liabilities from the interest rate fluctuation.

(b) Credit Risk

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

The carrying amount of financial assets is maximum exposure to credit risk. The maximum exposure to credit risk as of December 31, 2012 and 2011, is as follows:

		2012	2011
Available-for-sale financial assets	₩	2,832	2,376
Long-term deposits in MSA Escrow Fund		168,667	147,290
Trade and other receivables		1,005,563	967,425
Other financial assets		649,461	12,516
Cash and cash equivalents		372,260	807,731
	₩	2,198,783	1,937,338

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(c) Liquidity Risk

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

The maturity analysis with a residual contractual maturity of financial liabilities as of December 31, 2012 and 2011, is as follows:

2012		Carrying amount	Contractual cash flow	Within 3 months	Between 3 months and 1 year	Between 1 and 5 years	Beyond 5 years
Trade and other payables	₩	298,381	299,629	254,604	9,266	35,759	-
Short-term borrowings		91,868	93,964	25,687	68,277	-	-
Long-term borrowings		109,599	119,785	144	410	41,984	77,247
Current portion of long-term borrowings		2,912	3,126	159	2,967	-	-

(in millions of Korean won)

2011		Carrying amount	Contractual cash flow	Within 3 months	Between 3 months and 1 year	Between 1 and 5 years	Beyond 5 years
Trade and other payables	₩	311,421	312,555	95,050	208,109	7,338	2,058
Short-term borrowings		82,836	82,998	50,354	32,644	-	-
Long-term borrowings		37,847	45,568	175	542	44,550	301
Current portion of long-term borrowings		3,126	3,166	1,243	1,923	-	-

(in millions of Korean won)

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

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4.2 Capital Management

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

As of December 31, 2012 and 2011, the Group defines net debt and equity attributable to owners of the Parent as follows:

		2012	2011
Total borrowings	₩	204,379	123,809
Less:			
- Cash and cash equivalents		(372,260)	(807,731)
- Other financial assets		(649,186)	(11,089)
- Available-for-sale financial assets		(1,000)	(1,044)
Net debt(asset)		(818,067)	(696,055)
Equity attributable to owners of the parent	₩	5,194,419	4,788,130

(in millions of Korean won)

4.3 Fair Value Estimation

The table below analyzes financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1).
- Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (Level 2).
- Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (Level 3).

The following table presents the Group's financial assets and financial liabilities that are measured at fair value as of December 31, 2012:

		Level 1	Level 2	Level 3	Total
Assets					
Available-for-sale financial assets	₩	188,297	47,440	12,213	247,950
Total assets	₩	188,297	47,440	12,213	247,950

(in millions of Korean won)

The following table presents the Group's assets and liabilities that are measured at fair value as of December 31, 2011:

		Level 1	Level 2	Level 3	Total
Assets					
Available-for-sale financial assets	₩	187,311	42,604	12,009	241,924
Total assets	₩	187,311	42,604	12,009	241,924

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The fair value of financial instruments traded in active markets is based on quoted market prices at the statement of financial position date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, an entity in the same industry, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used for financial assets held by the Group is the current bid price. These instruments are included in Level 1. Instruments included in Level 1 consist primarily of KOSPI and KOSDAQ equity investments classified as trading securities or available for sale.

The fair value of financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined by using valuation techniques. These valuation techniques maximize the use of observable market data where it is available and rely as little as possible on entity specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in Level 2.

If one or more of the significant inputs is not based on observable market data, the instrument is included in Level 3.

Specific valuation techniques used to value financial instruments include:

- Quoted market prices or dealer quotes for similar instruments.
- The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows based on observable yield curves.
- The fair value of forward foreign exchange contracts is determined using forward exchange rates at the statement of financial position date, with the resulting value discounted back to present value.
- Other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments.

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5. Operating Segments

(1) The Group's reportable segments and details are as follows:

Operating segment	Principal operation
Tobacco	Manufacturing and selling tobaccos
Ginseng	Manufacturing and selling red ginseng
Real estate	Selling and renting real estate
Others	Manufacturing and selling pharmaceuticals, cosmetics and others

(2) Segment information on revenue and profit from operations for the years ended December 31, 2012 and 2011, follows:

2012		Tobacco	Ginseng	Real estate	Others	Segment total	Elimina-tion	Consoli-dated
Total segment sales	₩	2,839,860	899,726	44,247	395,466	4,179,299	(194,638)	3,984,661
Less: Inter-segment sales		61,101	71,483	7,856	54,198	194,638	(194,638)	-
External sales		2,778,759	828,243	36,391	341,268	3,984,661	-	3,984,661
Profit(loss) from operations		942,026	112,488	9,250	(6,633)	1,057,131	(21,201)	1,035,930

(in millions of Korean won)

2011		Tobacco	Ginseng	Real estate	Others	Segment total	Elimina-tion	Consoli-dated
Total segment sales	₩	2,624,430	1,025,181	250,579	41,814	3,942,004	(219,037)	3,722,967
Less: Inter-segment sales		78,893	92,321	42,931	4,892	219,037	(219,037)	-
External sales		2,545,537	932,860	207,648	36,922	3,722,967	-	3,722,967
Profit(loss) from operations		886,467	197,764	7,095	13,186	1,104,512	(14,171)	1,090,341

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(3) Segment information on assets and liabilities as of December 31, 2012 and 2011, are as follows:

2012		Tobacco	Ginseng	Real estate	Others	Segment total	Elimination	Consolidated
Assets								
Segment assets	₩	3,630,713	1,375,619	135,368	362,884	5,504,584	(349,720)	5,154,864
Equity accounted investments		-	-	52,647	3,130	55,777	-	55,777
Assets held for sale		762	-	-	-	762	-	762
		3,631,475	1,375,619	188,015	366,014	5,561,123	(349,720)	5,211,403
Unallocated assets								1,584,558
Total assets								6,795,961
Liabilities								
Segment liabilities		910,420	147,244	-	70,560	1,128,224	(142,569)	985,655
Unallocated liabilities								615,887
Total liabilities								1,601,542

(in millions of Korean won)

2011		Tobacco	Ginseng	Real estate	Others	Segment total	Elimination	Consolidated
Assets								
Segment assets	₩	3,332,975	1,128,405	154,456	382,278	4,998,114	(121,801)	4,876,313
Equity accounted investments		-	-	33,681	1,649	35,330	-	35,330
Assets held for sale		3,196	-	-	-	3,196	-	3,196
		3,336,171	1,128,405	188,137	383,927	5,036,640	(121,801)	4,914,839
Unallocated assets								1,361,577
Total assets								6,276,416
Liabilities								
Segment liabilities		766,856	136,388	-	71,461	974,705	(124,565)	850,140
Unallocated liabilities								541,198
Total liabilities								1,391,338

(in millions of Korean won)

(4) The major customers who contribute 10% or more of the Group's total revenues for the years ended December 31, 2012 and 2011, are as follows:

Segment	Major customer		2012	2011
Tobacco	Alokozay International Limited	₩	577,985	522,531

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6. Financial Instruments by Category

Categorizations of financial assets as of December 31, 2012 and 2011, are as follows:

2012		Loans and receivables	Assets at fair value through profit or loss	Derivative financial instruments	Assets classified as available-for-sale	Total
Cash and cash equivalents	₩	372,260	-	-	-	372,260
Financial assets as available-for-sale, current		-	-	-	1,000	1,000
Trade and other receivables, current		883,778	-	-	-	883,778
Other financial assets, current		649,186	-	-	-	649,186
Long-term deposits		168,667	-	-	-	168,667
Financial assets as available-for-sale, non-current		-	-	-	263,884	263,884
Long-term Trade and other receivables		121,784	-	-	-	121,784
Other financial assets, non-current		275	-	-	-	275
	₩	2,195,950	-	-	264,884	2,460,834

(in millions of Korean won)

2011		Loans and receivables	Assets at fair value through profit or loss	Derivative financial instruments	Assets classified as available-for-sale	Total
Cash and cash equivalents	₩	807,731	-	-	-	807,731
Financial assets as available-for-sale, current		-	-	-	1,044	1,044
Trade and other receivables, current		833,310	-	-	-	833,310
Other financial assets, current		11,089	-	-	-	11,089
Long-term deposits		147,290	-	-	-	147,290
Financial assets as available-for-sale, non-current		-	-	-	247,359	247,359
Long-term Trade and other receivables		134,115	-	-	-	134,115
Other financial assets, non-current		1,427	-	-	-	1,427
	₩	1,934,962	-	-	248,403	2,183,365

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Categorizations of financial liabilities as of December 31, 2012 and 2011, are as follows:

2012		Liabilities at fair value through profit or loss	Derivative financial instruments	Other financial liabilities at amortized cost	Other financial liabilities	Total
Borrowings, current	₩	-	-	91,868	-	91,868
Current portion of long-term borrowings		-	-	2,912	-	2,912
Borrowings, non-current		-	-	109,599	-	109,599
Trade and other payables, current		-	-	273,402	-	273,402
Trade and other payables, non-current		-	-	24,979	-	24,979
	₩	-	-	502,760	-	502,760

(in millions of Korean won)

2011		Liabilities at fair value through profit or loss	Derivative financial instruments	Other financial liabilities at amortized cost	Other financial liabilities	Total
Borrowings, current	₩	-	-	82,836	-	82,836
Current portion of long-term borrowings		-	-	3,126	-	3,126
Borrowings, non-current		-	-	37,847	-	37,847
Trade and other payables, current		-	-	285,390	-	285,390
Trade and other payables, non-current		-	-	26,031	-	26,031
	₩	-	-	435,230	-	435,230

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Income and loss of financial instruments by category for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Available-for-sale financial assets			
Gain (Loss) on valuation (Other comprehensive income(loss))	₩	1,220	(49,889)
Gain (Loss) on disposal (Profit or loss)		(287)	643
Interest income		229	69
Dividend income		6,366	5,248
Impairment		-	-
Cash and cash equivalents			
Interest income		30,551	32,632
Gain (Loss) on foreign currency translation		(170)	3,271
Foreign currency transaction gain (loss)		(1,878)	6,970
Trade and other receivables			
Interest income		5,836	2,089
Gain (Loss) on foreign currency translation		(50,226)	7,896
Foreign currency transaction gain (loss)		(10,253)	60
Other financial liabilities at amortized cost			
Interest costs		(10,216)	(4,233)
Gain (Loss) on foreign currency translation		5,479	93
Foreign currency transaction gain (loss)		(4,624)	(3,494)

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7. Available-for-sale Financial Assets

The changes in available-for-sale financial assets as of December 31, 2012 and 2011, are as follows:

		2012	2011
At January 1	₩	248,403	315,177
Additions		16,500	22,316
Disposals		(1,628)	(1,927)
Net gains (losses) transfer to equity		1,609	(65,145)
Transfer to others		-	(18,033)
Impairment losses		-	(3,988)
Net exchange difference		-	3
At December 31		264,884	248,403
Less: current portion		(1,000)	(1,044)
Non-current portion	₩	263,884	247,359

(in millions of Korean won)

Available-for-sale financial assets as of December 31, 2012 and 2011, are as follows:

		2012	2011
Available-for-sale debt instruments:			
Government and municipal bonds	₩	292	336
Corporate bonds		2,540	2,040
Total available-for-sale debt instruments		2,832	2,376
Available-for-sale equity instruments:			
Listed			
Yonhap Television News (YTN)		29,580	23,130
Oscotech, Inc.		869	2,049
Shinhan Financial Group Co., Ltd.		155,725	159,332
Rexahn Pharmaceuticals, Inc.		2,122	2,801
		188,296	187,312
Unlisted			
Dream Hub PFV Co., Ltd.		12,213	12,009
Others		61,543	46,706
		73,756	58,715
Total available-for-sale equity instruments		262,052	246,027
Total available-for-sale financial assets	₩	264,884	248,403

(in millions of Korean won)

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

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

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

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8. Trade and Other Receivables

Trade and other receivables as of December 31, 2012 and 2011, are as follows:

		2012		2011	
		Current	Non-current	Current	Non-current
Loans to employees	₩	7,196	22,491	13,424	32,441
Loans		661	6,928	1,917	8,540
Other receivables		84,559	27,529	62,910	22,281
Guarantee deposits		-	64,836	-	70,853
Accrued income		7,006	-	1,962	-
Trade receivables		784,356	-	753,097	-
	₩	883,778	121,784	833,310	134,115

(in millions of Korean won)

Trade and other receivables as of December 31, 2012 and 2011, reported in the consolidated statements of financial position, net of allowances, are as follows:

		2012		2011	
		Current	Non-current	Current	Non-current
Gross trade and other receivables	₩	912,506	121,784	849,691	134,115
Allowance account					
- Loans		(199)	-	(199)	-
- Other receivables		(2,304)	-	(2,235)	-
- Trade receivables		(26,225)	-	(13,947)	-
		(28,728)	-	(16,381)	-
Net amount	₩	883,778	121,784	833,310	134,115

(in millions of Korean won)

Changes in the allowance account for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Beginning	₩	16,381	8,809
Acquisition of subsidiary		-	6,904
Impairment		15,801	1,893
Reversal of impairment		-	(169)
Write-off		(3,450)	(1,045)
Net exchange difference		(4)	(11)
Ending	₩	28,728	16,381

(in millions of Korean won)

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The aging schedule of trade and other receivables as of December 31, 2012 and 2011, is as follows:

		2012	2011
Not past due	₩	470,756	534,899
Past due but not impaired			
Within 1 month		74,054	59,256
Between 1 and 2 months		51,070	58,873
Beyond 2 months		205,402	100,069
		330,526	218,198
Impaired		9,299	13,947
	₩	810,581	767,044

(in millions of Korean won)

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

Details of trade and other receivables that are measured at amortized cost as of December 31, 2012, and 2011, are as follows:

	2012				2011		
	Effective interest rate		Current	Non-current	Effective interest rate	Current	Non-current
Loans to employees	3.00~5.68%	₩	7,192	22,486	3.00~5.68%	13,422	32,427
Loans	1.7%~3.29%		-	4,650	3.13~7.29%	1,521	4,673
Other receivables	3.79%		8,300	16,601	3.79%	7,997	22,281
Guarantee deposits	1.7%~8.47%		-	62,400	2.50~7.29%	-	67,661
		₩	15,492	106,137		22,940	127,042

(in millions of Korean won)

Transferred trade receivables

The Group discounted its trade receivables through trade receivable factoring agreements with National Agricultural Cooperative Federation and other financial institutions in relation with the collecting sales payments with tobacco card.

In case the customers default, the Company has an obligation to pay the related amount to the bank. As a result, this transaction treated as a transaction with recourse, has been accounted for as collateralized borrowings. The borrowings recognized in relation to the said transaction as of December 31, 2012 and 2011, are ₩5,477 million and ₩6,975 million, respectively (Note 23).

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9. Long-term Deposits

Long-term deposits of December 31, 2012 and 2011, are as follows:

		2012	2011
MMF	₩	10,496	147,290
T-note		158,170	-
	₩	168,666	147,290

(in millions of Korean won)

As discussed in Note 32 to the consolidated financial statements, long-term deposits in MSA Escrow Fund are deposited to the United States government related to the export of tobacco to the United States. The payments of long-term deposits in MSA Escrow Fund for the years ended December 31, 2012 and 2011, are ₩34,906 million and ₩15,150 million, respectively.

Investment income on long-term deposits in MSA Escrow Fund for the years ended December 31, 2012 and 2011, is ₩18 million and ₩6,658 million, respectively.

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10. Property, Factory and Equipment

Changes in property, factory and equipment for the years ended December 31, 2012 and 2011, are as follows:

2012				
		Acquisition Cost	Accumulated depreciation and impairment cost	Net book value
Land	₩	518,056	-	518,056
Buildings		828,448	(299,733)	528,715
Structures		60,616	(33,617)	26,999
Machinery		1,139,624	(767,059)	372,565
Vehicles		10,962	(8,012)	2,950
Tools		53,223	(44,367)	8,856
Furniture and fixture		248,433	(182,577)	65,856
Others		1,266	-	1,266
Construction-in-progress		106,173	-	106,173
	₩	2,966,801	(1,335,365)	1,631,436

(in millions of Korean won)

2011				
		Acquisition Cost	Accumulated depreciation and impairment cost	Net book value
Land	₩	460,487	-	460,487
Buildings		825,388	(293,322)	532,066
Structures		65,022	(34,950)	30,072
Machinery		1,058,014	(692,974)	365,040
Vehicles		12,184	(8,637)	3,547
Tools		49,759	(39,888)	9,871
Furniture and fixture		233,286	(166,987)	66,299
Others		1,219	-	1,219
Construction-in-progress		115,745	-	115,745
	₩	2,821,104	(1,236,758)	1,584,346

(in millions of Korean won)

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2012								
		Opening net book value	Additions	Disposal	Depreciation	Exchange difference	Transfer	Net book amount
Land	₩	460,487	16,978	(27,930)	-	272	68,249	518,056
Buildings		532,066	13,804	(7,691)	(36,297)	(1,432)	28,265	528,715
Structures		30,072	853	(336)	(3,344)	(33)	(213)	26,999
Machinery		365,040	27,521	(2,105)	(82,769)	(751)	65,629	372,565
Vehicles		3,547	567	(168)	(1,271)	(166)	441	2,950
Tools		9,871	3,771	(11)	(4,900)	(28)	153	8,856
Furniture and fixture		66,299	31,489	(1,044)	(30,723)	(1,305)	1,140	65,856
Others		1,219	10	-	-	-	37	1,266
Construction-in-progress		115,745	168,450	(160)	-	533	(178,395)	106,173
	₩	1,584,346	263,443	(39,445)	(159,304)	(2,910)	(14,694)	1,631,436

(in millions of Korean won)

2011									
		Opening net book value	Additions	Acquisition of subsidiary	Disposal	Depreciation	Exchange difference	Transfer	Net book amount
Land	₩	436,950	975	150	(10,826)	-	(595)	33,833	460,487
Buildings		496,353	45,495	8,732	(1,727)	(32,086)	(4,671)	19,970	532,066
Structures		32,047	686	347	(265)	(3,346)	(102)	705	30,072
Machinery		381,380	12,208	11,889	(1,897)	(75,561)	(3,848)	40,869	365,040
Vehicles		1,789	1,201	1,478	(179)	(933)	(3)	194	3,547
Tools		12,166	2,606	150	(121)	(5,296)	(28)	394	9,871
Furniture and fixture		60,015	28,833	4,254	(724)	(30,650)	28	4,543	66,299
Others		749	-	-	(11)	-	-	481	1,219
Construction-in-progress		89,389	196,525	4,673	(102)	-	705	(175,445)	115,745
	₩	1,510,838	288,529	31,673	(15,852)	(147,872)	(8,514)	(74,456)	1,584,346

(in millions of Korean)

KT&G Corporation and Subsidiaries
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11. Intangible Assets

Changes in intangible assets for the years ended December 31, 2012 and 2011, are as follows:

2012		Good-will	Industrial property rights	Facility usage rights	Other intangible assets	Intangible assets under development	Total
At January 1, 2012	₩	87,902	23,454	24,387	106,641	16,234	258,618
Additions		-	1,041	1,658	2,122	-	4,821
Disposals		-	(70)	(1)	(134)	(721)	(926)
Transfer-in(out)		-	12,271	(1)	490	(12,270)	490
Amortization		-	(2,942)	-	(9,856)	-	(12,798)
Impairment / reversal		-	(15)	-	-	(43)	(58)
Exchange differences		(3,802)	347	(1)	(926)	(358)	(4,740)
Other changes		-	-	-	-	1,386	1,386
Acquisition cost		84,100	45,113	26,042	115,745	4,629	275,629
Accumulated depreciation and impairment cost		-	(11,027)	-	(17,408)	(401)	(28,836)
Net book amount	₩	84,100	34,086	26,042	98,337	4,228	246,793

(in millions of Korean won)

2011		Good-will	Industrial property rights	Facility usage rights	Other intangible assets	Intangible assets under development	Total
At January 1, 2011	₩	-	2,049	24,189	4,194	32,713	63,145
Additions		-	447	4,537	11,623	-	16,607
Disposals		-	(199)	(4,371)	(80)	(14,454)	(19,104)
Acquisition of subsidiary		87,902	20,952	33	94,857	12,728	216,472
Transfer-in(out)		-	276	-	-	(276)	-
Amortization		-	(78)	-	(4,416)	-	(4,494)
Impairment / reversal		-	-	-	-	(15,914)	(15,914)
Exchange differences		-	7	(1)	463	(158)	311
Other changes		-	-	-	-	1,595	1,595
Acquisition cost		87,902	33,060	24,387	122,670	32,795	300,814
Accumulated depreciation and impairment cost		-	(9,606)	-	(16,029)	(16,561)	(42,196)
Net book amount	₩	87,902	23,454	24,387	106,641	16,234	258,618

(in millions of Korean won)

Research and development expenses for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Cost of goods sold	₩	1,133	1,459
Selling and administrative expenses		37,106	29,359
Cost of goods sold		38,239	30,818

(in millions of Korean won)

Exchange loss of ₩3,802 million arising from the translation of goodwill of PT Trisakti Purwosari Makmur, one of subsidiaries, is accounted for as a deduction from goodwill and loss on currency translation of foreign operations (other comprehensive income).

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12. Investment Property

Changes in investment property for the years ended December 31, 2012 and 2011, are as follows:

2012		Land	Building	Total
Beginning net book value	₩	45,314	143,037	188,351
Additions		-	51	51
Transfers		2,863	(2,997)	(134)
Depreciation		-	(6,282)	(6,282)
Acquisition cost		48,177	179,787	227,964
Accumulated depreciation		-	(45,978)	(45,978)
Net book amount	₩	48,177	133,809	181,986

(in millions of Korean won)

2011		Land	Building	Total
Beginning net book value	₩	36,550	84,933	121,483
Additions		-	2,136	2,136
Transfer to property, factory and equipment		(268)	(291)	(559)
Transfer from property, factory and equipment		9,032	61,272	70,304
Depreciation		-	(5,013)	(5,013)
Acquisition cost		45,314	184,834	230,148
Accumulated depreciation		-	(41,797)	(41,797)
Net book amount	₩	45,314	143,037	188,351

(in millions of Korean won)

The amounts recognized in profit or loss from investment property for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Rental income	₩	33,032	21,243
Direct operating expense		(7,394)	(5,013)
	₩	25,638	16,230

(in millions of Korean won)

Fair values and book values of investment property as of December 31, 2012 and 2011, are as follows:

		2012		2011	
		Fair value	Book value	Fair value	Book value
Land	₩	312,735	48,177	313,922	45,314
Building		190,214	133,809	198,204	143,037
	₩	502,949	181,986	512,126	188,351

(in millions of Korean won)

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13. Non-current Assets Held for Sale and Discontinued Operations

The Group entered into sales contracts with Kim Jae Chil and two others on Nam Woolsan Cosmo Tower's land on January 6, 2012, building and others and with HT&D Co., Ltd. to sell the Gyeonggi branch's land, building and others on February 23, 2012.

Also, the Group has sales contracts on Gwangju, Samcheok, Yangyang, Hwasun branch's land, buildings and others with the city governments of Gwangju and Samcheok, Chuncheon District Court and Hansol Techno Co., Ltd, respectively. on January 11, 2012

Changes in non-current assets held for sale for the year ended December 31, 2012, are as follows:

		2012				
		Land	Buildings	Structures	Machinery	Total
At January 1, 2012						
Acquisition cost	₩	2,273	1,429	197	-	3,899
Accumulated depreciation		-	(553)	(150)	-	(703)
Net book amount	₩	2,273	876	47	-	3,196
Changes						
Transfer from property, factory and equipment	₩	6,491	2,686	71	45	9,293
Transfer from Investment property		562	4,288	14	-	4,864
Disposals		(8,701)	(7,731)	(114)	(45)	(16,591)
	₩	(1,648)	(757)	(29)	-	(2,434)
At 2012						
Acquisition cost	₩	625	215	64	-	904
Accumulated depreciation		-	(96)	(46)	-	(142)
Net book amount	₩	625	119	18	-	762

(in millions of Korean won)

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14. Pledged Assets

The following assets were pledged as collateral for the Group's borrowings and others as of December 31, 2012:

Asset		Book amount		Borrow-ings	Collateralized amount	Lender / Leaseholder
Property, factory and equipment / investment property	₩	76,674	Short-term borrowings	15,000	64,147	Hana Bank and 3 others
			Current portion of long-term borrowings	412		Korea Development Bank
			Long-term borrowings	10,034		
Investment Property		80,783	Leasehold deposits received	8,169	8,502	Metlife Insurance Co., Ltd. and 29 others
Property, factory and equipment		1,071	ACH pleaged	-	1,071	Bank of Oklahoma
Trade receivables		11,294	Short-term borrowings	11,294	11,294	Citibank Korea Inc.
Total	₩	169,822		44,909	85,014	

(in millions of Korean won)

The following assets were pledged as collateral for the Group's borrowings and others as of December 31, 2011:

Asset		Book amount		Borrowings	Collateralized amount	Lender / Leaseholder
Property, factory and equipment	₩		Short-term orrowings	21,906		
Investment Property		82,776	Current portion of Long-term borrowings	549	94,946	Hana Bank and 5 others
Investment Property			Leasehold deposits received	9,821		
Investment Property		89,705	Leasehold deposits received	6,576	7,469	Metlife Insurance Korea Co.,Ltd. and 27 others
Total	₩	172,481		38,852	102,415	

(in millions of Korean won)

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15. Investments in Associates

Investments in associates as of December 31, 2012 and 2011, are as follows:

Associates	Location	Principal operation		2012 Interest (%)	2012 Carrying Amount	2011 Interest (%)	2011 Carrying Amount
Cosmo Tabacco Co., Ltd.	Mongolia	Manufacturing and selling tobaccos	₩	40.00	-	40.00	-
Lite Pharm Tech, Inc	Korea	Manufacturing and Medical supplies		25.34	857	25.34	637
Korean Carbon Finance, Inc	Korea	Emissions trading		20.00	932	20.00	1,013
JR CR-REIT IV Co., Ltd.	Korea	Selling and renting of real estate		49.02	13,570	49.02	13,819
KVG REIT 1 Co., Ltd.	Korea	Selling and renting of real estate		29.67	7,160	29.67	7,354
KOCREF REIT 17 Co., Ltd.	Korea	Selling and renting of real estate		22.06	6,827	22.06	6,872
JR REIT V Co., Ltd.	China	Selling and renting of real estate		34.63	5,581	34.63	5,635
JR REIT VIII Co., Ltd.	Korea	Selling and renting of real estate		21.74	10,008	-	-
LSK Global Pharma Services Co., Ltd	Korea	Research and developing new drug		23.15	1,343	-	-
JR REIT X Co., Ltd.	Korea	Selling and renting of real estate		28.78	9,500	-	-
Total			₩		55,778		35,330

(in millions of Korean won)

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Changes in investments in associates and subsidiaries for the years ended December 31, 2012 and 2011, are as follows:

2012		Beginning balance	Acquisition	Share of profit(loss)	Other changes	Ending balance
Associates						
Lite Pharm Tech, Inc	₩	637	-	219	-	856
Korean Carbon Finance, Inc.		1,013	-	(81)	-	932
JR CR-REIT IV Co., Ltd.		13,819	-	768	(1,017)	13,570
KVG REIT 1 Co., Ltd.		7,354	-	333	(527)	7,160
KOCREF REIT 17 Co., Ltd.		6,872	-	186	(231)	6,827
JR REIT V Co., Ltd.		5,635	-	367	(421)	5,581
JR REIT VIII Co., Ltd.		-	10,000	349	(341)	10,008
LSK Global Pharma Services Co., Ltd		-	1,500	(157)	-	1,343
JR REIT X Co., Ltd.		-	9,500	-	-	9,500
	₩	35,330	21,000	1,984	(2,537)	55,777

(in millions of Korean won)

2011		Beginning balance	Acquisition	Share of profit(loss)	Other changes	Ending balance
Lite Pharm Tech, Inc	₩	645	-	(8)	-	637
Korean Carbon Finance, Inc.		952	-	61	-	1,013
JR CR-REIT IV Co., Ltd.		-	3,995	625	9,199	13,819
KVG REIT 1 Co., Ltd.		-	-	284	7,070	7,354
KOCREF REIT 17 Co., Ltd.		-	7,000	81	(209)	6,872
JR REIT V Co., Ltd.		-	5,600	274	(239)	5,635
	₩	1,597	16,595	1,317	15,821	35,330

(in millions of Korean won)

[1] The Group reclassified ₩17,300 million of available-for-sale financial assets to investments in associates during the year ended December 31, 2011.

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Summary of the associates' financial information as of December 31, 2012 and 2011, follows:

		2012			
		Assets	Liabilities	Revenues	Profit/(loss)
Lite Pharm Tech, Inc.	₩	3,832	452	4,239	1,192
Korean Carbon Finance, Inc.		4,739	84	741	(397)
JR CR-REIT IV Co., Ltd.		66,139	36,591	5,309	1,566
KVG REIT 1 Co., Ltd.		52,144	28,014	5,583	1,078
KOCREF REIT 17 Co., Ltd.		66,738	35,792	5,193	865
JR REIT V Co., Ltd.		31,327	15,211	2,230	1,009
JR REIT VIII Co., Ltd.		109,750	63,714	4,822	1,984
LSK Global Pharma Services Co., Ltd.		3,807	2,108	7,738	(680)

(in millions of Korean won)

		2011			
		Assets	Liabilities	Revenues	Profit/(loss)
Lite Pharm Tech, Inc.	₩	4,041	1,527	1,549	(32)
Korean Carbon Finance, Inc.		5,158	97	1,143	303
JR CR-REIT IV Co., Ltd.		65,722	35,658	6,758	1,583
KVG REIT 1 Co., Ltd.		52,829	28,045	5,540	993
KOCREF REIT 17 Co., Ltd.		65,749	34,600	128	441
JR REIT V Co., Ltd.		31,480	15,208	540	831

(in millions of Korean won)

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16. Inventories

Inventories as of December 31, 2012 and 2011, are as follows:

		2012			2011		
		Acquisition	Allowance	Book mount	Acquisition	Allowance	Book mount
Merchandise	₩	8,074	(521)	7,553	5,678	(881)	4,797
Finished goods		348,664	(1,738)	346,926	307,308	(1,782)	305,526
Work in progress		452,730	(3,107)	449,623	328,087	(3,647)	324,440
Raw materials		821,905	(3,093)	818,812	874,359	(2,974)	871,385
Supplies		25,633	-	25,633	26,158	-	26,158
By-products		6,076	-	6,076	6,738	-	6,738
Unfinished housing		227	-	227	-	-	-
Lots		6,551	-	6,551	-	-	-
Goods-in-transit		45,395	-	45,395	33,255	-	33,255
	₩	1,715,255	(8,459)	1,706,796	1,581,583	(9,284)	1,572,299

(in millions of Korean won)

The cost related inventories for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Cost of sales			
- Loss(profit) on inventory valuation	₩	1,481	574
- Loss on retirement of inventories		3,392	-
Other expenses			
- Loss on retirement of inventories		3,313	7,270
	₩	8,186	7,844

(in millions of Korean won)

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17. Cash and Cash Equivalents

Cash and cash equivalents as of December 31, 2012 and 2011, are as follows:

		2012	2011
Cash on hand	₩	4,292	4,554
Demand deposits		177,743	213,845
Short-term investment assets		190,225	589,332
	₩	372,260	807,731

(in millions of Korean won)

Other financial assets as of December 31, 2012 and 2011, are as follows:

		2012	2011
Long-term Financial assets			
Time deposits	₩	143	1,285
Deposit in current account		17	6
Money trust		115	136
		275	1,427
Short-term Financial assets			
Time deposits		187,115	3,442
Money trust		271,000	-
Certificate of deposit		191,071	7,647
		649,186	11,089
	₩	649,461	12,516

(in millions of Korean won)

Restricted financial assets as of December 31, 2012 and 2011, are as follows:

	Description		2012	2011
Cash and cash equivalents	Specific research purpose	₩	1,357	-
Other financial assets	Pledge		1,771	9,677
Long-term other financial assets	Deposits		17	34
		₩	3,145	9,711

(in millions of Korean won)

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18. Equity and Share Premium

Details of share capital as of December 31, 2012, and 2011, are as follows:

		2012	2011
Number of ordinary shares			
- Authorized		800,000,000	800,000,000
- Issued		137,292,497	137,292,497
Par value per share	₩	5,000	5,000
Ordinary shares	₩	954,959,485,000	954,959,485,000

(in Korean won, except number of shares)

The Parent Company has reacquired and retired 53,699,400 treasury shares. Accordingly, as of December 31, 2012, the Parent Company's ordinary shares differ from the aggregate par value of issued shares by ₩268,497 million.

Changes in the number of shares for the years ended December 31, 2012 and 2011, are as follows:

	2012			2011		
	Ordinary shares	Treasury shares	Total	Ordinary shares	Treasury shares	Total
Beginning	137,292,497	(11,543,697)	125,748,800	137,292,497	(9,643,697)	127,648,800
Acquisition of treasury shares	-	-	-	-	(2,000,000)	(2,000,000)
Issuance of treasury shares	-	150,000	150,000	-	100,000	100,000
Ending	137,292,497	(11,393,697)	125,898,800	137,292,497	(11,543,697)	125,748,800

(Number of shares)

19. Treasury Shares

Changes in the treasury shares for the years ended December 31, 2012 and 2011, are as follows:

		2012		2011	
		Number of shares	Carrying amount	Number of shares	Carrying amount
Beginning	₩	11,543,697	343,522	9,643,697	216,827
Acquisition of treasury shares		-	-	2,000,000	129,671
Issuance of treasury shares		(150,000)	(4,463)	(100,000)	(2,976)
Ending	₩	11,393,697	339,059	11,543,697	343,522

(in millions of Korean won)

Changes in gain on reissuance of treasury shares for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Beginning	₩	485,922	482,129
Gain on reissuance of treasury shares before tax		8,061	5,004
Less: tax at 24.2%		(1,951)	(1,211)
Gain on reissuance of treasury shares, net of tax		6,110	3,793
Ending	₩	492,032	485,922

(in millions of Korean won)

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20. Reserves

Details of reserves as of December 31, 2012 and 2011, are as follows:

		2012	2011
Available-for-sale financial assets reserve	₩	(30,635)	(31,855)
Exchange differences on translating foreign operations		(27,925)	(15,501)
Legal reserve		602,937	602,937
Voluntary reserve		2,466,732	2,107,732
	₩	3,011,109	2,663,313

(in millions of Korean won)

Available-for-sale financial assets reserve as of December 31, 2012 and 2011, are summarized as follows:

		2012	2011
Available-for-sale financial assets reserve before tax	₩	(40,415)	(42,025)
Tax effect		9,780	10,170
	₩	(30,635)	(31,855)

(in millions of Korean won)

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

Details of the Group's voluntary reserve as of December 31, 2012 and 2011, are as follows:

		2012	2011
Reserve for business rationalization	₩	12,851	12,851
Reserve for research and human resource development		60,000	60,000
Reserve for business expansion		698,881	698,881
Other reserve		1,695,000	1,336,000
	₩	2,466,732	2,107,732

(in millions of Korean won)

Reserve for Business Rationalization

Until December 10, 2002 under the Special Tax Treatment Control Law, investment tax credits were allowed for certain investments. The Group was, however, required to appropriate from retained earnings, the amount of tax benefits received, and transfer such amount into a reserve for business rationalization. Effective December 11, 2002, the Group was no longer required to establish a reserve for business rationalization despite tax benefits received for certain investments and, consequently, the existing balance is now regarded as a voluntary reserve.

Reserve for Research and Human Resource Development

Reserve for research and human resource development was appropriated in order to utilize certain tax deduction benefits through the early recognition of future expenditures. This reserve is restored to retained earnings in accordance with the relevant tax laws. Such reserves are taken back into taxable income in the year of restoration.

Reserve for Business Expansion and other reserve

Reserves without specific purposes are restored to retained earnings by a resolution at a general meeting of shareholders.

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21. Retained Earnings

Changes in retained earnings for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Beginning	₩	1,022,126	1,151,359
Transfer from other reserve		(359,000)	(544,000)
Dividends		(402,396)	(382,946)
Profit for the period		725,118	816,929
- Less: non-controlling interests		12,920	(871)
Actuarial losses, net of tax		(18,579)	(19,449)
- Less: non-controlling interests		155	1,104
Others		(3,919)	-
Ending	₩	976,425	1,022,126

(in millions of Korean won)

22. Accounts Payable and Other Finance Liabilities

Accounts payable and other finance liabilities as of December 31, 2012 and 2011, are as follows:

		2012		2011	
		Current	Non-current	Current	Non-current
Leasehold deposits received	₩	-	24,979	154	25,069
Accounts payable		48,190	-	81,938	-
Withholdings		136,814	428	137,344	644
Accrued expenses		144,901	-	131,775	-
Other payables		80,311	-	71,523	318
	₩	410,216	25,407	422,734	26,031

(in millions of Korean won)

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23. Borrowings

Details of borrowings as of December 31, 2012 and 2011, are as follows:

		2012	2011
Current			
Bank borrowings[1]	₩	84,221	75,021
Other borrowings		7,647	7,815
Bank borrowings (Current portion of long-term borrowings)		293	549
Other borrowings (Current portion of long-term borrowings)		2,619	1,619
Convertible bonds		-	958
		94,780	85,962
Non-current			
Bank borrowings		11,932	10,220
Other borrowings		119	2,738
Convertible bonds		11,110	12,577
Convertible redeemable preference shares		69,429	12,312
Redeemable preference shares		17,009	-
		109,599	37,847
	₩	204,379	123,809

(in millions of Korean won)

Out of the above borrowings, ₩5,477 million and ₩6,975 million as of December 31, 2012 and 2011, respectively, are related to trade receivable factoring contract. In case the customers default, the Company has an obligation to pay the related amounts to the bank. As a result, this transaction, treated as a transaction with recourse, has been accounted for as a collateralized borrowing (Note 8). In addition, bank borrowings are collateralized with the Group's property, factory and equipment (Note 14).

Details of bank borrowings as of December 31, 2012 and 2011, are as follows:

Currency	Creditor	Latest maturity date	Annual interest rate(%) 2012		2012	2011
Korean won	National Agricultural Cooperative Federation, other	Short-term Borrowings	3.65	₩	26,823	6,351
Korean won	Citibank	Short-term Borrowings	CD(91)+1.25		14,230	28,829
Korean won	Hana Bank	Short-term Borrowings	1.75~5.32		43,239	36,109
Foreign currency	BCA	Short-term Borrowings	-		-	4,235
Korean won	National Agricultural Cooperative Federation	2016. 07. 20	1.50		756	756
Korean won	National Agricultural Cooperative Federation	2017. 06. 21	1.50		1,260	-
Korean won	Hana Bank	2017. 03. 31	3.04		966	1,036
Korean won	Korea Development Bank	2014. 11. 07	4.45		8,000	8,474
Korean won	Korea Development Bank	2018. 06. 09	3.09		291	-
Korean won	Hana Bank	2017. 03. 31	4.58		881	-
					96,446	85,790

(in millions of Korean won)

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Convertible Bond

The Group issued 9.5% convertible bonds at a par value of ₩12,410 million on December 14, 2011. The bonds will mature four years from the issue date and become convertible into shares at the rate of ₩1,199 per share.

The fair value of the liability component, included in non-current borrowings, was calculated using the market interest rate for an equivalent non-convertible bond. The residual amount, representing the value of the equity conversion option, is included in shareholders' equity in other reserves, net of income taxes.

Convertible redeemable preference shares

The Group issued convertible redeemable preference shares at ₩18,000 million on November 19, 2011. The convertible instrument will mature ten years from the issue date. The instrument can be converted into 1,090,909 ordinary shares at any time, and automatically converts upon maturity. If KT&G Life Sciences will be not listed by the end of 2015, recourse is available.

The Group issued convertible redeemable preferred shares at ₩26,000 million on January 9, 2012. The convertible instrument will mature five years from the issue date. The instrument can be converted into 94,079 ordinary shares at any time before maturity, and automatically converts upon maturity. If Somang Cosmetics Co., Ltd. will be not listed by the end of 2016, recourse is available.

The Group issued convertible redeemable preferred shares at ₩35,216 million on September 14, 2012. The convertible instrument will mature ten years from the date of establishment of QCP 2011 Corporate Partnership Private Equity Fund. The instrument can be converted into 6,978,948 ordinary shares at any time after five years from its issuance. If this SPC will not be liquidated and apportioned in ten years, recourse is available.

Redeemable preference shares

The Group issued redeemable preference shares at ₩17,761 million during 2012. Recourse will be available ten years from the date of establishment of QCP 2011 Corporate Partnership Private Equity Fund. If this SPC will not be liquidated and apportioned in ten years, recourse is available.

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24. Defined Benefit Liability

The amounts recognized on the statements of income for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Defined benefit plans :			
Current service cost	₩	37,850	32,401
Interest expenses		9,130	8,029
Past service cost		(116)	
Expected return on plan assets		(6,511)	(5,850)
Gains on settlement		86	489
		40,439	35,069
Defined contribution plans :			
Pension costs		2,222	1,194
Total	₩	42,661	36,263

(in millions of Korean won)

Termination benefits for the year ended December 31, 2012, were ₩1,194 million. Out of total expenses, ₩14,742 million (2011: ₩13,699 million) and ₩27,919 million (2011: ₩22,564 million) were included in 'cost of sales' and 'selling and administrative expenses', respectively.

The movements in the defined benefit liability for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Present value of funded defined benefit liability	₩	286,420	232,940
Present value of unfunded defined benefit liability		1,909	437
Fair value of plan assets		(180,685)	(150,295)
Liability in the statement of financial position	₩	107,644	83,082

(In millions of Korean won)

The movements in the defined benefit obligation for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Beginning balance	₩	233,377	176,811
Business combination		-	8,330
Current service cost		37,850	32,401
Interest cost		9,130	8,029
Past service cost		(116)	-
Gains on settlement		86	489
Actuarial (gains)/losses (before tax)		24,138	24,648
Payments, including the amount transferred to the defined contribution plan		(14,672)	(17,516)
Changes in accrued expenses		(16)	188
Net exchange difference		(1,448)	(3)
Ending balance	₩	288,329	233,377

(In millions of Korean won)

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The movements in the fair value of plan assets for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Beginning balance	₩	150,295	128,487
Business combination		-	2,642
Expected return on plan assets		6,511	5,850
Actuarial gains/(losses) (before tax)		(186)	(259)
Payment into plan assets		32,797	22,929
Payments, including the amount transferred to the defined contribution plan		(8,173)	(9,591)
Changes in accrued expenses		(536)	237
Net exchange difference		(23)	-
Ending balance	₩	180,685	150,295

(In millions of Korean won)

Actual return on plan assets for the years ended December 31, 2012 and 2011, are ₩6,324 million and ₩5,591 million, respectively.

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

Actuarial gains and losses recognized as other comprehensive income for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Actuarial gains (losses) before income tax	₩	(24,324)	(24,907)
Income tax effects		5,745	5,458
Actuarial gains (losses) after income tax	₩	(18,579)	(19,449)

(In millions of Korean won)

The components of plan assets as of December 31, 2012 and 2011, are as follows:

		2012	2011
Short-term trading financial assets	₩	105,130	86,346
Available-for-sale financial assets		69,316	57,814
Others		6,239	6,135
	₩	180,685	150,295

(In millions of Korean won)

The principal actuarial assumptions as of December 31, 2012 and 2011, are as follows:

	2012	2011
Rate of salary increases	3.09%~5.57%	3.34%~8.00%
Discount rate	3.27%~3.37%	3.80%~8.25%
Expected return on plan assets	3.30%~4.30%	3.20%~6.00%

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Sensitivities in respect of the key assumptions used to measure the defined benefit plan are as follows:

		1% Increase	1% Decrease
Rate of salary increases:			
Increase (decrease) in defined benefit obligations	₩	28,661	(25,154)
Increase (decrease) in retirement benefits before tax		4,857	(4,457)
Discount rate:			
Increase (decrease) in defined benefit obligations		(26,689)	31,239
Increase (decrease) in retirement benefits before tax		(2,525)	2,619
Expected rate of return on plan assets:			
Increase (decrease) in retirement benefits before tax		(1,547)	1,374

(In millions of Korean won)

Adjustments for the differences between initial assumptions and actual figures as of December 31, 2012 and 2011, 2010, 2009, 2008 and January 1, 2008, are as follows:

		December 31, 2012	December 31, 2011	December 31, 2010	December 31, 2009	December 31, 2008	January 1, 2008
Present value of defined benefit liability	₩	288,329	233,377	177,109	163,462	39,598	18,448
Fair value of plan assets		(180,685)	(150,295)	(128,490)	(127,576)	(16,356)	(11,442)
Deficit (Surplus) in the funded plans		107,644	83,082	48,619	35,886	23,242	7,006
Experience adjustments on plan liabilities		(10,724)	(5,256)	5,147	5,730	729	-
Experience adjustments on plan assets		(160)	(289)	(607)	(842)	116	-

(In millions of Korean won)

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25. Classification of Operating Income

(1) Material items of operating income and expense

Operating income is calculated as gross profit net of selling and administrative expenses and other income and expenses were excluded.

(2) Employee benefit costs for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Salaries	₩	504,853	463,684
Retirement benefits		42,661	36,263
Termination benefits		1,194	3,573
Employee welfare		61,044	52,644
	₩	609,752	556,164

(in millions of Korean won)

(3) Depreciation and amortization for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Depreciation	₩	165,586	152,885
Amortization		12,798	4,494
	₩	178,384	157,379

(in millions of Korean won)

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(4) Selling and administrative expenses for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Salaries	₩	325,164	293,993
Retirement benefits		28,683	25,330
Employee welfare		41,935	35,628
Travel		13,420	12,285
Communications		5,816	5,275
Utilities		9,157	7,518
Taxes and dues		18,439	16,104
Supplies		3,953	4,106
Rent		30,640	27,769
Depreciation		48,189	44,769
Amortization		12,798	4,284
Repairs and maintenance		11,445	8,866
Vehicles		12,151	10,561
Insurance		2,215	2,053
Commissions		216,607	169,756
Freight and custody		46,503	43,589
Conferences		4,796	3,026
Advertising		310,967	266,075
Training		7,966	7,999
Prizes and rewards		2,745	3,733
Cooperation		1,497	1,420
Normal research and development		37,106	29,358
Bad debts expense		15,730	1,537
	₩	1,207,922	1,025,034

(in millions of Korean won)

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(5) Details of other income for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Foreign currency transaction gain	₩	16,540	35,746
Foreign currency translation gain		5,646	17,966
Gain on sale of investments in subsidiaries		-	1,139
Gain on sale of property, factory and equipment		34,337	45,852
Gain on sale of intangible assets		359	7,016
Miscellaneous revenues		18,219	11,180
	₩	75,101	118,899

(in millions of Korean won)

(6) Details of other expenses for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Foreign currency transaction loss	₩	33,295	32,210
Foreign currency translation loss		50,563	6,706
Impairment loss on other receivables		71	187
Donations		23,249	18,531
Loss on sale of property, factory and equipment		7,749	3,493
Impairment loss on property, factory and equipment		201	-
Loss on sale of intangible assets		456	647
Impairment loss on intangible assets		58	15,914
Loss on retirement of inventories		3,313	7,270
Miscellaneous expenses		4,148	3,653
	₩	123,103	88,611

(in millions of Korean won)

26. Expenses by Nature

Expenses by nature for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Changes in inventories	₩	(134,497)	(75,265)
Raw materials and consumables purchased		1,653,653	1,300,819
Salary and wage		504,853	463,684
Retirement and termination benefits		43,855	39,836
Depreciation charges		165,586	152,885
Amortization charges		12,798	4,494
Employee benefits		61,044	52,644
Advertising costs		311,140	266,430
Service fees		255,059	202,386
Other expenses		198,344	313,323
Total cost of sales, selling and administrative expenses and other expenses	₩	3,071,835	2,721,236

(in millions of Korean won)

27. Financial Income and Costs

Financial income and costs for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Financial cost			
Interest costs	₩	(10,216)	(4,233)
Loss on sale of available-for-sale financial assets		(287)	-
Impairment loss on available-for-sale financial assets		-	(3,988)
		(10,503)	(8,221)
Financial income			
Interest income		36,616	34,790
Dividend income		6,366	5,248
Investment income on long-term deposits in MSA Escrow Fund		18	6,658
Gain on sale of available-for-sale financial assets		-	643
		43,000	47,339
Net financial income	₩	32,497	39,118

(in millions of Korean won)

Details of interest costs for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Borrowings	₩	(4,828)	(3,306)
Trade and other payables		(1,203)	(927)
Others		(4,185)	-
		(10,216)	(4,233)

(in millions of Korean won)

Details of interest income for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Deposits	₩	30,551	32,632
Available-for-sale financial assets		229	69
Trade and other receivables		5,836	2,089
	₩	36,616	34,790

(in millions of Korean won)

28. Income Tax

Income tax expense for the years ended December 31, 2012 and 2011, consists of:

		2012	2011
Current tax expense:			
Current tax on profits for the year	₩	283,093	291,009
Adjustments in respect of prior years		2,416	4,018
Total current tax		285,509	295,027
Deferred tax:			
Origination and reversal of temporary differences		8,011	29,624
Total income tax expense	₩	293,520	324,651
Current tax charged / (credited) directly to equity		3,771	19,484
Income tax expense	₩	297,291	344,135

(in millions of Korean won)

Reconciliation of net income before tax and income expense for the years ended December 31, 2012 and 2011, follows:

		2012	2011
Profit before tax	₩	1,022,409	1,161,064
Income tax based on statutory rate	₩	271,331	280,951
Tax effects of:			
Incomes not deductible for tax purposes		(317)	-
Expenses not deductible for tax purposes		6,443	9,233
Tax credit		(4,082)	(3,339)
Adjustment in respect of prior years		2,416	3,927
Re-measurement of deferred tax expense – change in the Korean tax rate		-	28,161
Non-deduction of dividend income		(233)	-
Profit of subsidiaries		24,722	25,955
Others		(2,989)	(753)
Income tax expense	₩	297,291	344,135

(in millions of Korean won)

The tax (charged) / credited directly to other comprehensive income and equity as of and for the years ended December 31, 2012 and 2011, is as follows:

		2012			2011		
		Before tax	Tax (charge) credit	After tax	Before tax	Tax (charge) credit	After tax
The tax (charge) / credit relating to components of other comprehensive income:							
Fair value gains (losses) from available-for-sale financial assets	₩	1,610	(390)	1,220	(65,145)	15,256	(49,889)
Actuarial gains (losses) on retirement benefit obligations		(24,324)	5,745	(18,579)	(24,907)	5,458	(19,449)
Gains (Losses) on foreign operation		(1,517)	367	(1,150)	79	(19)	60
		(24,231)	5,722	(18,509)	(89,973)	20,695	(69,278)
The income tax (charged) / credited directly to equity:							
Gains (Losses) on disposal of treasury shares		8,061	(1,951)	6,110	5,004	(1,211)	3,793
	₩	(16,170)	3,771	(12,399)	(84,969)	19,484	(65,485)

(in millions of Korean won)

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The analysis of deferred tax assets and deferred tax liabilities as of December 31, 2012 and 2011, is as follows:

		2012	2011
Deferred tax assets			
Deferred tax asset to be recovered after more than 12 months	₩	100,212	76,914
Deferred tax asset to be recovered within 12 months		39,172	30,814
		139,384	107,728
Deferred tax liabilities			
Deferred tax liability to be recovered after more than 12 months		(358,054)	(317,298)
Deferred tax liability to be recovered within 12 months		(1,443)	(2,532)
		(359,497)	(319,830)
Deferred tax assets (liabilities), net	₩	(220,113)	(212,102)

(in millions of Korean won)

The gross movement on the deferred income tax account for the years ended December 31, 2012 and 2011, is as follows:

		2012	2011
Beginning balance	₩	(212,102)	(156,436)
Acquisition of subsidiary(business combination)		-	(26,042)
Tax charged to the statement of income		(13,733)	(44,861)
Tax charge / (credit) relating to components of other comprehensive income		5,722	15,237
Ending balance	₩	(220,113)	(212,102)

(in millions of Korean won)

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The movements in deferred income tax assets and liabilities during the year, without taking into consideration the offsetting of balances within the same tax jurisdiction, are as follows:

		January 1, 2012	Beginning adjust-ment	Credited to profit (Charged to loss)	Charged to other comprehensive income	Charged or credited directly to equity	December 31, 2012
Deferred tax assets							
Available-for-sale financial assets	₩	11,812	(697)	2	-	-	11,117
Accrued expense		25,325	-	1,648	-	-	26,973
Defined benefit liabilities		2,917	148	170	5,745	-	8,980
Depreciation		6,065	-	2,777	-	-	8,842
Long-term advances from customers		3,133	-	580	-	-	3,713
Specific sales		5,398	-	51	-	-	5,449
Change in value of available -for-sale financial assets		10,169	-	-	(390)	-	9,779
Allowance for doubtful accounts		-	1,856	2,585	-	-	4,441
Foreign currency gains and losses		91	-	(91)	-	-	-
	₩	64,910	1,307	7,722	5,355	-	79,294
Deferred tax liabilities							
Investment in subsidiaries	₩	(216,677)	697	(24,722)	-	-	(240,702)
Treasury stock		(8,924)	-	116			(8,808)
Cost of specific sales		(2,532)	-	(78)	-	-	(2,610)
Reserve		(21,868)	-	(331)	-	-	(22,199)
Provision for advanced depreciation		(5,194)	-	(9,299)	-	-	(14,493)
Others		(21,817)	(1,856)	12,711	367	-	(10,595)
	₩	(277,012)	(1,159)	(21,603)	367	-	(299,407)

(in millions of Korean won)

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		January 1, 2011	Beginning adjust-ment	Credited to profit (Charged to loss)	Charged to other comprehen-sive income	Charged or credited directly to equity	Change in tax rate	December 31, 2011
Deferred tax assets								
Available-for-sale financial assets	₩	9,861	-	877	-	-	1,074	11,812
Accrued expense		20,708	138	2,562	-	-	1,917	25,325
Defined benefit liabilities		966	204	1,503	-	-	244	2,917
Depreciation		5,329	(481)	854	-	-	363	6,065
Long-term advances from customers		2,292	103	738	-	-	-	3,133
Specific sales		3,905	-	1,493	-	-	-	5,398
Foreign currency gains and losses		1,313	86	(1,308)	-	-	-	91
	₩	44,374	50	6,719	-	-	3,598	54,741
Deferred tax liabilities								
Investment in subsidiaries	₩	(172,123)	-	(15,268)	-	-	(29,286)	(216,677)
Treasury stock		(8,183)	-	70	-	-	(811)	(8,924)
Cost of specific ales		(1,692)	-	(840)	-	-	-	(2,532)
Change in value of available-for-sale financial assets		(5,087)	-	-	15,256	-	-	10,169
Reserve		(9,190)	(361)	(10,997)	-	-	(1,320)	(21,868)
Provision for advanced depreciation		(4,722)	-	-	-	-	(472)	(5,194)
Others		187	(25,731)	3,616	(19)	130	-	(21,817)
	₩	(200,810)	(26,092)	(23,419)	15,237	130	(31,889)	(266,843)

(in millions of Korean won)

As of December 31, 2012 and 2011, the aggregate amounts of temporary differences associated with undistributed earnings of subsidiaries for which deferred tax liabilities have not been recognized were ₩1,003 million and ₩15,953 million, respectively.

KT&G Corporation and Subsidiaries
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29. Earnings per Share

Basic earnings per share is calculated by dividing the profit attributable to equity holders of the Company by the weighted average number of ordinary shares in issue during the year excluding ordinary shares purchased by the Company and held as treasury shares (Note 19).

Basic earnings per ordinary share for the years ended December 31, 2012 and 2011, is as follows:

		2012	2011
Profit for the period	₩	738,037 million	816,058 million
Weighted-average number of ordinary shares outstanding		125,756,587	126,505,112
Basic and diluted earnings per share in won	₩	5,869	6,451

(in Korean won, except number of shares)

30. Dividends

Dividend distribution to the Company's shareholders amounted to ₩402,396 million for the year ended December 31, 2011, was paid in March 2012. A dividend in respect of the year ended December 31, 2012, of ₩3,200 per share, amounting to a total dividend of ₩402,876 million, is to be proposed at the annual general meeting on February 28, 2013. These financial statements do not reflect this dividend payable.

KT&G Corporation and Subsidiaries
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31. Cash Generated from Operations

(1) Cash generated from operations for the years ended December 31, 2012 and 2011, are as follows:

		2012	2011
Profit	₩	725,118	816,929
Adjustments for			
Income tax expense		297,291	344,135
Finance costs		10,503	8,221
Finance income		(43,000)	(47,339)
Depreciation		165,586	152,885
Amortization		12,798	4,494
Retirement and termination benefits		40,600	39,836
Foreign currency translations loss		50,563	6,706
Loss on the write-down of inventories		1,481	574
Impairment loss on trade and other receivables		15,801	1,893
Loss on sale of property, factory and equipment		7,749	3,493
Loss on sale of intangible assets		456	647
Impairment loss on intangible assets		-	15,914
Other expense		3,783	7,270
Share of gain of associates		(2,222)	(1,325)
Share of loss of associates		239	8
Foreign currency translations gain		(5,646)	(17,966)
Reversal of impairment loss on trade and other receivables		-	(169)
Gain on sale of property, factory and equipment		(34,337)	(45,852)
Gain on sale of intangible assets		(359)	(7,016)
Gain on sale of investment in subsidiaries		-	(1,139)
		1,246,404	1,282,199
Changes in working capital:			
Trade and other receivables		(147,370)	(134,692)
Advance payments		(8,413)	(25,893)
Prepaid expenses		2,582	(2,603)
Prepaid tobacco excise and other taxes		(55,649)	(21,179)
Inventories		(162,565)	15,212
Trade and other payables		75,162	40,760
Advance receipts		23,681	6,410
Tobacco excise and other taxes payable		92,000	(11,167)
Payment of retirement benefits		(38,918)	(37,399)
Cash generated from operations	₩	1,026,914	1,111,648

(in millions of Korean won)

(2) Non-cash transactions

		2012
Reclassification of property, factory and equipment to non-current assets held for sale	₩	9,293
Reclassification of property, factory and equipment to investment property		4,910
Reclassification of investment property to non-current assets held for sale		4,864

(in millions of Korean won)

KT&G Corporation and Subsidiaries
Notes to Consolidated Financial Statements
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32. Contingencies

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

As of December 31, 2012, tobacco lawsuits claiming damages of ₩584 million are filed against the Group and the Korean government. The amount of the liability the Group may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of December 31, 2012. Additionally, as of December 31, 2012, the Group is involved in fifteen lawsuits as a defendant for alleged damages totaling ₩3,652 million. The amount of the liability the Group may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of December 31, 2012.

As of December 31, 2012, the Group has letter of credit agreements with Korea Exchange Bank and other banks with limits in the aggregate of USD 60,700 thousand.

As of December 31, 2012, the Group's trade receivables from the export of cigarettes are insured against non-payment up to USD 12,200 thousand by an export guarantee insurance with the Korea Export Insurance Corporation.

As of December 31, 2012, the Group has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries and for an opening of L/C for import and customs with relation to a subsidiary located in U.S.A(Global Trading Inc.) for up to USD 40,000 thousand by Korea Exchange Bank and others.

The Group has maintained a contract with the farmers who grow six-year old green ginseng for purchase volume guarantees and recorded contractual amounts paid to the farmers as advance payments in the amount of ₩188,687 million (non-current: ₩ 139,291 million; current: ₩49,396 million) as of December 31, 2012.
As of December 31, 2012, the Group has an accounts receivable loan agreement with a limit of ₩105,000 million with Hana Bank and other financial institutions.

As of December 31, 2012, the Group has a trade bill loan agreement with a limit of ₩10,000 million with Korea Exchange Bank and other financial institutions.

As of December 31, 2012, the Group has a loan agreement with a limit of ₩86,310 million with Shinhan Bank and other financial institutions.

As of December 31, 2012, the Group has provided two blank notes, 13 notes amounting to ₩14,200 million and five blank checks to Resolution and Finance Corporation and others as collateral for its borrowings and trade agreements.

As of December 31, 2012, the Group and 28 other companies are guaranteed ₩240,000 million by Seoul Guarantee Insurance Co., Ltd. related to the Yongsan International Commercial Development Project.

KT&G Corporation and Subsidiaries
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On March 17, 2011, the Group signed the memorandum of understanding (MOU) on global investment partnership with National Pension Service to jointly invest in foreign assets with a limit of ₩800,000 million. Following this MOU, the Group entered into a joint investment agreement with Q Capital Partners Co., Ltd., which is a general partner of private equity fund, on November 11, 2011.

Relative to the acquisition of Somang Cosmetics Co., Ltd., the Parent Company entered into a contract with a former owner of the acquiree, Kang Seok-Chang ("the Individual Shareholder"). Details of the contract are as follows:

1) Conditional put option granted to the Individual Shareholder

The Parent Company shall be required to purchase Individual Shareholder's shares, in whole or in part, at the agreed price if the following conditions are met:
- Somang Cosmetics Co., Ltd. satisfies all the listing requirements.
- Notwithstanding the written request of the Individual Shareholder, Somang Cosmetics Co., Ltd. is not able to undertake the necessary procedures for listing, due to the Parent Company's objection, within three years after the Parent Company acquires Somang Cosmetics Co., Ltd.

2) Right of first refusal held by the Parent Company

The Individual shareholder shall not be permitted to make any transfer of its shares, in whole or in part, unless the Individual Shareholder has offered them first to the Parent Company.

3) Tag-along right held by Individual Shareholder

In the event that the Parent Company proposes to enter into a transaction or a series of related transactions with a third party purchaser to dispose of 50% or more of its shares, then the Individual Shareholder shall elect to participate in such disposition upon the terms and conditions no less favorable than those applicable to the Parent Company.

In relation to the acquisition of Mazence, Inc., the Parent Company entered into a contract with a former owner of the acquiree, Gwak Tae-Hwan ("Individual Shareholder"). Details of the contract are as follows:

1) Restriction of disposal

The Individual shareholder shall not be permitted to dispose of its shares, in whole or in part, within one year after Mazence, Inc. is listed.

2) Right of first refusal held by the Parent Company

The Individual shareholder shall not be permitted to make any transfer of its shares, in whole or in part, unless the Individual Shareholder has offered them first to the Parent Company.

3) Tag-along right held by the Individual Shareholder

In the event that the Parent Company proposes to enter into a transaction or a series of related transactions with a third party purchaser to dispose of its shares, then the Individual Shareholder shall elect to participate in such disposition upon the terms and conditions no less favorable than those applicable to the Parent Company.

KT&G Corporation and Subsidiaries
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33. Related Party Transactions

The Group has no significant transactions and receivables, liabilities with related parties, for the year ended December 31, 2012.

The guarantee provided by related parties as of December 31, 2012 and 2011, are as follows:

				2012		2011	
Guarantor	Guarantee for	Purpose		Limit	Guarantee amount	Limit	Guarantee amount
Kang Seok-chang	Somang Cosmetics Co., Ltd.	Application funds	₩	2,591	2,893	21,175	16,748

(in millions of Korean won)

The compensation paid or payable to key management for employee services for the years ended December 31, 2012 and 2011, consists of:

		2012	2011
Short-term employee benefits	₩	27,738	21,658
Retirement benefits		3,549	2,227
		31,287	23,885

(in millions of Korean won)

34. Basis of Translating Financial Statements

The financial statements are expressed in Korean won and have been translated into U.S. dollars at the rate of ₩1,071.1 to US $ 1, the basic exchange rate on December 31, 2012, posted by Seoul Money Brokerage Services, solely for the convenience of the reader. This translation should not be construed as a representation that any or all of the amounts shown could be converted into U.S. dollars at this or any other rate.


Global Player KT&G
Feel Moment, Fill Life

Corporate Governance

Min, Young Jin
President & CEO

Independent Non-executive Directors

Kim, In Ho
Chairman of BOD

Kim, Won Yong

Kim, Duk Hwi

Cho, Kyu Ha

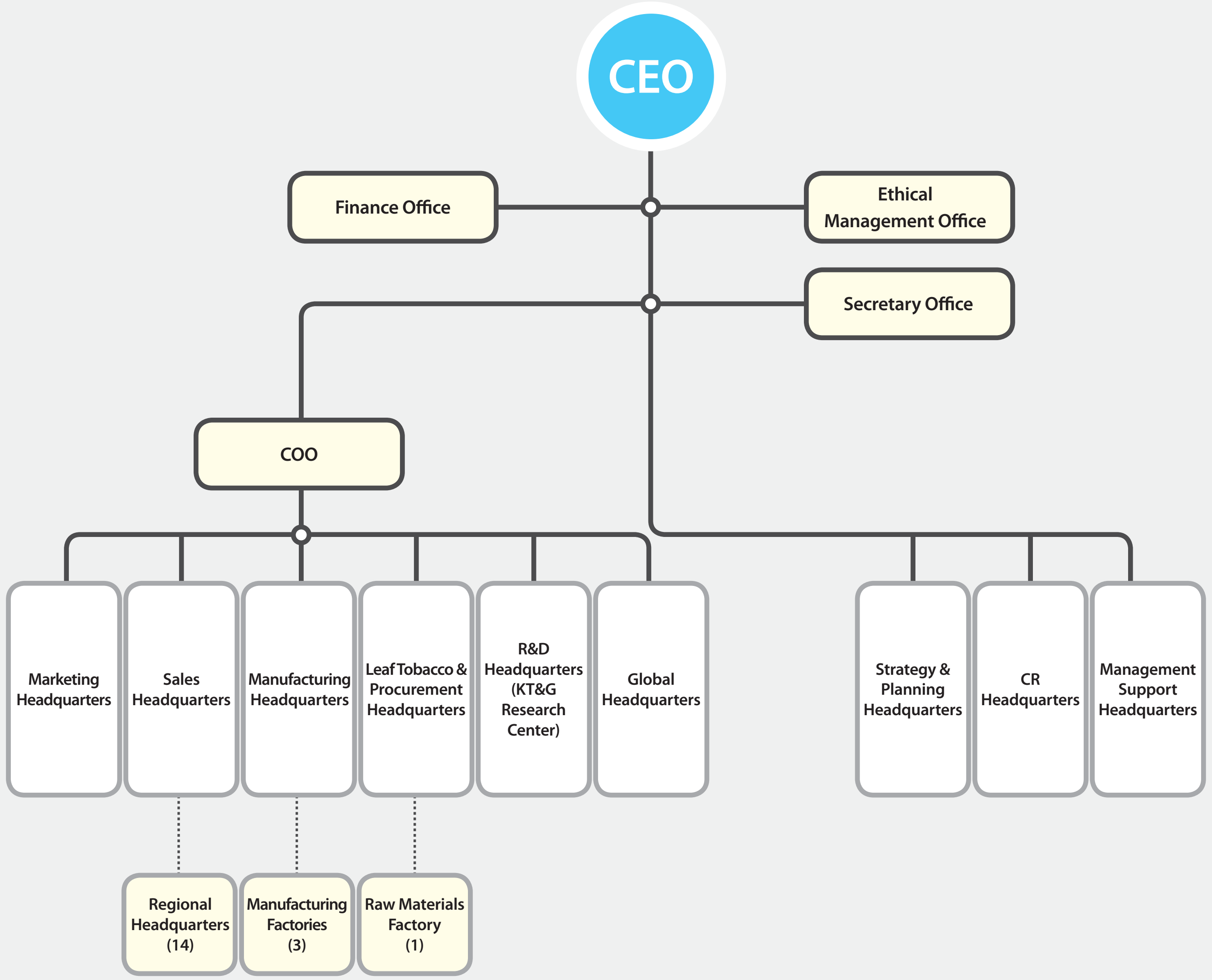
Lee, Wang Jae

Kim, Jung Sik

Chung, Young Kee

Son, Won Ik

Organizational Structure



Organizational Structure

KT&G operates three independent offices under the CEO: the Secretary Office, the Finance Office, and the Ethical Management Office. The company also has nine headquarters for its domestic and overseas operations. We have fourteen regional headquarters and five factories for domestic operations, and seven subsidiaries and three factories overseas.

Overseas Subsidiaries and Branches

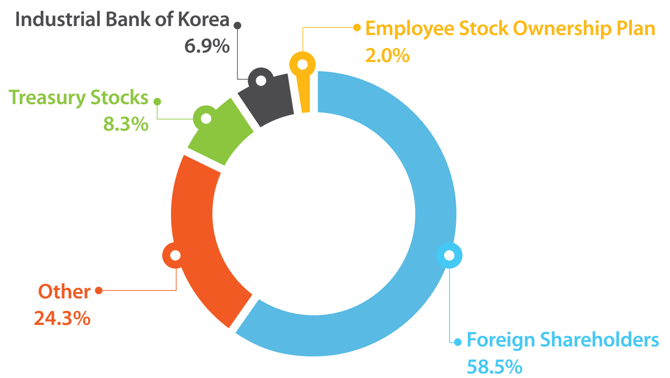
Overseas Offices

U.S, China, Russia, Turkey, Iran, Indonesia

Overseas Factories

Iran, Russia, Turkey, Indonesia

Ownership Structure



- Capital Stock: KRW955 billion
- Number of Authorized Shares: 800,000,000
- Number of Shares Issued 137,292,497
- Shareholders' Equity: KRW4,903 billion

INQUIRIES

- INVESTOR RELATIONS DEPARTMENT
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  KT&G Tower, 416, Yeongdong-daero, Gangnam-gu, Seoul, 135-549, Korea
  Tel. (82-2) 3404-4522~24, 4535~37 Fax. (82-2) 3404-4278

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