

KT&G CORPORATION

Separate Financial Statements

December 31, 2017 and 2016

(With Independent Auditors' Report Thereon)

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Independent Auditors' Report

Based on a report originally issued in Korean

The Board of Directors and Shareholders
KT&G Corporation:

We have audited the accompanying separate financial statements of KT&G Corporation (the "Company"), expressed in Korean won, which comprise the separate statements of financial position as of December 31, 2017 and 2016, and the separate statements of comprehensive income, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's responsibility of the Separate Financial Statements

Management is responsible for the preparation and fair presentation of these separate financial statements in accordance with Korean International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of separate financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion on these separate financial statements based on our audits. We conducted our audits in accordance with Korean Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the separate financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the separate financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the separate financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the separate financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the separate financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

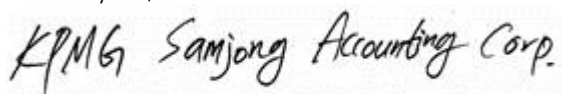
In our opinion, the separate financial statements present fairly, in all material respects, the separate financial position of the Company as at December 31, 2017 and 2016 and of its separate financial performance and its separate cash flows for the years then ended in accordance with Korean International Financial Reporting Standards.

Other matters

The procedures and practices utilized in the Republic of Korea to audit such separate financial statements may differ from those generally accepted and applied in other countries.

The accompanying separate financial statements as of and for the year ended December 31, 2016 have been translated into United States dollars solely for the convenience of the reader and such translation does not comply with K-IFRS. We have audited the translation and, in our opinion, the separate financial statements expressed in Korean won have been translated into dollars on the basis set forth in note 4 to the separate financial statements.

KPMG Samjong Accounting Corp.
Seoul, Korea
February 28, 2018

A handwritten signature in black ink that reads "KPMG Samjong Accounting Corp." in a cursive, flowing script.

This report is effective as of February 28, 2018, 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 separate financial statements and notes thereto. Accordingly, the readers of the audit report should understand that the above audit report has not been updated to reflect the impact of such subsequent events or circumstances, if any.

KT&G CORPORATION
Separate Statements of Financial Position

As of December 31, 2017 and 2016

<i>In millions of won and thousands of U.S. dollars</i>	<i>Note</i>	2017 Korean won	2017 U.S. dollars (note 4)	2016 Korean won
Assets		₩	\$	₩
Property, plant and equipment	5, 16	1,267,825	1,183,335	1,117,268
Intangible assets	6	27,235	25,420	28,928
Investment property	7, 16	325,423	303,736	335,196
Investments in associates and joint ventures	8, 32	51,930	48,469	58,230
Investments in subsidiaries	9, 32	1,208,228	1,127,710	1,154,925
Available-for-sale financial assets	10, 33	454,051	423,793	364,305
Long-term deposits in MSA Escrow Fund	11, 33, 35	510,223	476,221	503,592
Long-term prepaid expenses		4,583	4,277	5,398
Other financial assets	14, 16, 33, 35	6,340	5,918	-
Long-term trade and other receivables	12, 32, 33	80,535	75,168	68,017
Total non-current assets		3,936,373	3,674,047	3,635,859
Inventories	13	872,085	813,968	914,702
Current available-for-sale financial assets	10, 33	-	-	1,500
Current other financial assets	14, 33, 34, 36	1,530,000	1,428,038	1,620,000
Prepaid tobacco excise and other taxes		255,822	238,774	439,413
Trade and other receivables	12, 26, 32, 33	951,435	888,030	1,140,598
Advance payments		20,259	18,907	22,272
Prepaid expenses		4,164	3,886	5,733
Cash and cash equivalents	14, 33, 34	1,104,825	1,031,197	688,735
Total current assets		4,738,590	4,422,800	4,832,953
Total assets		₩ 8,674,963	\$ 8,096,847	₩ 8,468,812

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Financial Position, Continued

As of December 31, 2017 and 2016

<i>In millions of won and thousands of U.S. dollars</i>	<i>Note</i>	2017 Korean won	2017 U.S. dollars (note 4)	2016 Korean won
Equity				
Ordinary shares	1, 17	₩ 954,959 \$	891,319 ₩	954,959
Other capital surplus	17	3,582	3,343	3,582
Treasury shares	18	(328,157)	(306,288)	(328,157)
Gain on sales of treasury shares	18	513,776	479,537	513,776
Reserves	19	5,009,301	4,675,472	4,366,268
Retained earnings	20	990,096	924,115	1,068,469
Total equity		7,143,557	6,667,498	6,578,897
Liabilities				
Long-term trade and other payables	16, 20, 25, 32	21,655	20,212	6,848
Long-term advance receipts		582	543	319
Provision for doubtful debts	24	3,086	2,880	-
Net defined benefit liability	25	19,084	17,812	47,121
Deferred income tax liabilities	30	35,969	33,572	73,328
Total non-current liabilities		80,376	75,019	127,616
Short-term borrowings	23, 33, 34	1,959	1,828	3,851
Trade and other payables	16, 20, 32, 33	386,587	360,824	436,270
Advance receipts		1,801	1,681	972
Income tax payable	30	145,929	136,204	174,192
Tobacco excise and other taxes payable		914,754	853,793	1,147,014
Total current liabilities		1,451,030	1,354,330	1,762,299
Total liabilities		1,531,406	1,429,349	1,889,915
Total equity and liabilities		₩ 8,674,963 \$	8,096,847 ₩	8,468,812

See accompanying notes to the separate financial statements.

KT&G CORPORATION

Separate Statements of Comprehensive Income

For the years ended December 31, 2017 and 2016

<i>In millions of won and thousands of U.S. dollars, except earnings per share</i>	<i>Note</i>	<i>2017 Korean won</i>	<i>2017 U.S. dollars (note 4)</i>	<i>2016 Korean won</i>
Sales:	26,32,35			
Manufacture of tobacco		₩ 2,672,324	2,494,236	2,670,305
Real estate		190,003	177,340	184,734
Exports of leaf tobacco and others		137,761	128,581	113,136
		3,000,088	2,800,157	2,968,175
Cost of sales:	26,27,32			
Manufacture of tobacco		(883,887)	(824,983)	(861,301)
Real estate		(123,051)	(114,850)	(119,427)
Exports of leaf tobacco and others		(91,625)	(85,519)	(68,391)
		(1,098,563)	(1,025,352)	(1,048,119)
Gross profit		1,901,525	1,774,805	1,920,056
Selling, general and administrative expenses	27,32	(656,678)	(612,916)	(614,979)
Operating profit		1,244,847	1,161,889	1,305,077
Other income	28,32	118,401	110,510	126,578
Other expenses	28,32	(241,886)	(225,767)	(91,848)
Finance income	29,33	137,000	127,870	69,493
Finance costs	29,33	(19,465)	(18,168)	(8,936)
Net finance income	29,33	117,535	109,702	60,557
Profit before income tax		1,238,897	1,156,334	1,400,364
Income tax expense	30	(264,001)	(246,407)	(313,017)
Profit for the period		₩ 974,896	909,927	1,087,347
Other comprehensive income (loss):				
Items that will not be reclassified to profit or loss				
Remeasurements of net defined benefit liability, net of tax		₩ 15,200	14,187	(18,878)
Items that are or may be reclassified subsequently to profit or loss				
Unrealized net changes in fair value of available-for-sale financial assets, net of tax		29,118	27,177	14,199
Other comprehensive income for the period, net of tax		44,318	41,364	(4,679)
Total comprehensive income for the period		₩ 1,019,214	951,291	1,082,668
Earnings per share in won and U.S. dollars:				
Basic and diluted	31	₩ 7,721	7.21	8,618

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Changes in Equity

For the year ended December 31, 2017

<i>In millions of won</i>		Ordinary shares	Other capital surplus	Treasury shares	Gain on sales of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2017	₩	954,959	3,582	(328,157)	513,776	4,366,268	1,068,469	6,578,897
Total comprehensive income for the period:								
Profit for the year		-	-	-	-	-	974,896	974,896
Other comprehensive income (loss):								
Remeasurements of net defined benefit liability, net of tax		-	-	-	-	-	15,200	15,200
Unrealized net changes in fair value of available-for-sale financial assets, net of tax		-	-	-	-	29,118	-	29,118
Total other comprehensive income (loss)		-	-	-	-	29,118	15,200	44,318
Total comprehensive income for the year		-	-	-	-	29,118	990,096	1,019,214
Transactions with owners, recorded directly in equity:								
Dividends		-	-	-	-	-	(454,554)	(454,554)
Transfer from reserve for research and human resource development		-	-	-	-	(10,000)	10,000	-
Transfer to unconditional reserve		-	-	-	-	623,915	(623,915)	-
Total transactions with owners		-	-	-	-	613,915	(1,068,469)	(454,554)
Balance at December 31, 2017	₩	954,959	3,582	(328,157)	513,776	5,009,301	990,096	7,143,557

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Changes in Equity, Continued

For the year ended December 31, 2017

<i>In thousands of U.S. dollars (note 4)</i>	Ordinary shares	Other capital surplus	Treasury shares	Gain on sales of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2017	\$ 891,319	3,343	(306,288)	479,537	4,075,293	997,265	6,140,469
Total comprehensive income for the period:							
Profit for the period	-	-	-	-	-	909,927	909,927
Other comprehensive income (loss):							
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	14,187	14,187
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	27,177	-	27,177
Total other comprehensive income (loss)					27,177	14,187	41,364
Total comprehensive income for the period	-	-	-	-	27,177	924,114	951,291
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(424,262)	(424,262)
Transfer from reserve for research and human resource development	-	-	-	-	(9,334)	9,334	-
Transfer to unconditional reserve	-	-	-	-	582,336	(582,336)	-
Total transactions with owners	-	-	-	-	573,002	(997,264)	(424,262)
Balance at December 31, 2017	\$ 891,319	3,343	(306,288)	479,537	4,675,472	924,115	6,667,498

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Changes in Equity, Continued

For the year ended December 31, 2016

<i>In millions of won</i>		Ordinary shares	Other capital surplus	Treasury shares	Gain on sales of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2016	₩	954,959	3,582	(337,062)	494,648	3,784,467	995,886	5,896,480
Total comprehensive income for the year:								
Profit for the period		-	-	-	-	-	1,087,347	1,087,347
Other comprehensive loss:			-					
Remeasurements of net defined benefit liability, net of tax		-	-	-	-	-	(18,878)	(18,878)
Unrealized net changes in fair value of available-for-sale financial assets, net of tax		-	-	-	-	14,199	-	14,199
Total other comprehensive loss			-			14,199	(18,878)	(4,679)
Total comprehensive income for the year		-	-	-	-	14,199	1,068,469	1,082,668
Transactions with owners, recorded directly in equity:								
Dividends		-	-	-	-	-	(428,284)	(428,284)
Donation of treasury shares		-	-	8,905	19,128	-	-	28,033
Transfer from reserve for research and human resource development		-	-	-	-	(10,000)	10,000	-
Transfer to unconditional reserve		-	-	-	-	577,602	(577,602)	-
Total transactions with owners		-	-	8,905	19,128	567,602	(995,886)	(400,251)
Balance at December 31, 2016	₩	954,959	3,582	(328,157)	513,776	4,366,268	1,068,469	6,578,897

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Cash Flows

For the years ended December 31, 2017 and 2016

<i>In millions of won and thousands of U.S. dollars</i>	<i>Note</i>	2017 Korean won	2017 U.S. dollars (note 4)	2016 Korean won
Cash flows from operating activities				
Cash generated from operations	36 ₩	1,441,666	1,345,591	1,694,203
Income tax paid		(339,724)	(317,084)	(342,058)
Net cash provided by (used in) operating activities		1,101,942	1,028,507	1,352,145
Cash flows from investing activities	36			
Interest received		44,984	41,987	34,270
Dividends received		90,252	84,237	18,395
Proceeds from sale of property, plant and equipment		4,288	4,002	15,360
Proceeds from sale of intangible assets		1,350	1,260	476
Proceeds from sale of non-current assets held for sale		-	-	5,800
Proceeds from investments in associates and joint ventures		7,319	6,831	13,095
Disposition of Investments in Subsidiaries		17,724	16,543	-
Proceeds from sale of available-for-sale financial assets		22,600	21,094	33,988
Collection of loans		13,245	12,363	13,167
Withdrawal of guarantee deposits		17,371	16,214	12,083
Acquisition of property, plant and equipment		(247,395)	(230,908)	(118,665)
Acquisition of intangible assets		(2,000)	(1,867)	(6,910)
Acquisition of investments in associates and joint ventures		(1,000)	(933)	(19,000)
Acquisition of investments in subsidiaries		(97,202)	(90,724)	(3,065)
Acquisition of available-for-sale financial assets		(89,613)	(83,641)	(31,000)
Increase in loan		(9,809)	(9,155)	-
Payments of guarantee deposits		(19,519)	(18,218)	(18,509)
Payments of long-term deposits in MSA Escrow Fund		(72,040)	(67,239)	(89,663)
Increase in other financial assets, net		83,660	78,084	(342,058)
Net cash provided by investing activities		(235,785)	(220,070)	(482,236)
Cash flows from financing activities	36			
Dividends paid		(454,554)	(424,262)	(428,284)
Increase in deposits received		(4,710)	(4,396)	(3,704)
Decrease in deposits received		9,515	8,881	4,199
Net cash provided by (used in) financing activities		(449,749)	(419,777)	(427,789)
Effect of exchange rate fluctuation on cash held		(318)	(297)	181
Net increase in cash and cash equivalents		416,090	388,360	442,301
Cash and cash equivalents at January 1		688,735	642,837	444,376
Cash and cash equivalents at December 31	₩	1,104,825	1,031,197	886,677

See accompanying notes to the separate financial statements.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

1. Organization and Description of Business

KT&G Corporation (the "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 Company changed its name to Korea Tobacco and Ginseng Corporation pursuant to the Korea Tobacco and Ginseng Corporation Act. Also, pursuant to the Act on Management Reform and Privatization of Public Enterprises, proclaimed on August 28, 1997 and enforced on October 1, 1997, the Company was excluded from the application of the Act for the Management of Government Invested Enterprises. Accordingly, the Company became an entity existing and operating under the Commercial Act of Korea. The Korean government sold 28,650,000 shares of the Company to the public during 1999 and the Company listed its shares on the Korea Exchange on October 8, 1999. On December 27, 2002, the Company changed its name again to KT&G Corporation from Korea Tobacco and Ginseng Corporation.

As of December 31, 2017, the Company has three manufacturing plants, including the Shintanjin plant, and 14 local headquarters and 123 branches for the sale of tobacco throughout the country. Also, the Company has the Gimcheon plant for fabrication of leaf tobacco and the Cheonan printing plant for the manufacturing of packaging. The head office of the Company is located at 71, Beotkkot-gil, 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 split the Company into two companies by setting up a subsidiary for its red ginseng business segment effective January 1, 1999. The separation was accomplished by the Company's contribution of the assets and liabilities in the red ginseng business segment into a wholly-owned subsidiary, Korea Ginseng Corporation.

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

The ownership of the Company's issued ordinary shares as of December 31, 2017 is held as follows:

Shareholder	Number of shares	Percentage of ownership
National Pension Service	12,482,705	9.09%
Industrial Bank of Korea	9,510,485	6.93%
Employee Share Ownership Association	2,849,619	2.08%
Treasury shares	11,027,370	8.03%
Others	101,422,318	73.87%
	137,292,497	100.00%

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

2. Basis of Preparation

(a) Statement of Compliance

The separate financial statements have been prepared in accordance with Korean International Financial Reporting Standards ("K-IFRS") as prescribed in *the Act on External Audits of Corporations*.

These separate financial statements were prepared in accordance with K-IFRS No. 1034 *Financial Reporting* as part of the period covered by the Company's K-IFRS annual separate financial statements.

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

The separate financial statements were authorized for issue by the Board of Directors on February 1st, 2018.

(b) Basis of Measurement

The separate financial statements have been prepared on the historical cost basis, except for the following material items in the separate statements of financial position:

- Available-for-sale financial assets measured at fair value
- Liabilities for defined benefit plans recognized at the net of the total present value of defined benefit obligations less the fair value of plan assets

(c) Functional and Presentation Currency

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

(d) Use of Estimates and Judgments

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

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

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

- Note 3 – classification of financial instruments;
- Note 9 – classification of joint arrangements.

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

- Note 9 – impairment test: key assumptions underlying recoverable amounts;
- Note 25 – measurement of defined benefit obligations: key actuarial assumptions; and
- Notes 24 and 34 – recognition and measurement of contingencies: key assumptions about likelihood and

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

magnitude of an outflow of resources.

2. Basis of Preparation, Continued

(e) Measurement of Fair Values

A number of the Company's accounting policies and disclosures require the measurement of fair values, for both financial and non-financial assets and liabilities. The Company has an established control framework with respect to the measurement of fair values. This includes a valuation team that has overall responsibility for overseeing all significant fair value measurements, including Level 3 fair values, and reports directly to the CFO.

The valuation team regularly reviews significant unobservable inputs and valuation adjustments. If third party information, such as broker quotes or pricing services, is used to measure fair values, then the valuation team assesses the evidence obtained from the third parties to support the conclusion that such valuations meet the requirements of K-IFRS, including the level in the fair value hierarchy in which such valuations should be classified.

Significant valuation issues are reported to the Company's Audit Committee.

When measuring the fair value of an asset or a liability, the Company uses market observable data as far as possible. Fair values are categorized into different levels in a fair value hierarchy based on the inputs used in the valuation techniques as follows:

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

If the inputs used to measure the fair value of an asset or a liability fall into different levels of the fair value hierarchy, then the fair value measurement is categorized in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. The Company recognizes transfers between levels of the fair value hierarchy at the end of the reporting period during which the change has occurred.

Further information about the assumptions made in measuring fair values is included in following notes:

- Note 7 – investment property
- Note 33 – financial instruments

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies

The accounting policies, except for the application of the amendment standard effective from January 1, 2017, set out below have been applied consistently to all periods presented in these separate financial statements.

- K-IFRS No.1007, 'Statement of Cash Flows'

Amendments to K-IFRS No.1007 clarify that the changes in liabilities arising from financing activities are disclosed separately by changes arising from cash flows and non-cash changes and etc. The amendments do not have a material impact on the Company's financial statements.

- K-IFRS No.1012, 'Income Taxes'

Amendments to K-IFRS No.1012 clarify that the existence of a deductible temporary difference depends solely on a comparison of the carrying amount of an asset and its tax base at the end of the reporting period. The amendments do not have a material impact on the Company's financial statements.

The significant accounting policies applied by the Company in preparation of its separate financial statements are included below.

- K-IFRS 1112, 'Disclosure of Interests in Other Entities'

Amendments to K-IFRS No.1112 clarify that the company not release the financial summary of its subsidiaries, joint ventures of associates and apply the K-IFRS 1112 to subsidiaries, joint ventures of associates classified as scheduled to be sold or included in such a distribution asset group. The amendments do not have a material impact on the Company's financial statements.

(a) Subsidiaries, Associates and Joint Ventures in the Separate Financial Statements

These separate financial statements are prepared and presented in accordance with K-IFRS No.1027. The Company applied the cost method to investments in subsidiaries, associates and joint ventures in accordance with K-IFRS No. 1027. Dividends from a subsidiaries, associates and joint ventures are recognized in profit or loss when the right to receive the dividend is established.

(b) Property, Plant and Equipment

All property, plant 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 Company 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.

Property, plant and equipment, except for land and other tangible fixed assets and constituted of tree and others, are depreciated on a straight-line basis over estimated useful lives that appropriately reflect the pattern in which the asset's future economic benefits are expected to be consumed.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(b) Property, Plant and Equipment, Continued

The estimated useful lives of the Company's assets are as follows:

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

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 recoverable amount. Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized in other income and expense in the statement of comprehensive income.

(c) Borrowing Costs

The Company capitalizes borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Other borrowing costs are recognized in expense as incurred. A qualifying asset is an asset that requires a substantial period of time to get ready for its intended use or sale. Financial assets and inventories that are manufactured or otherwise produced over a short period of time are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

To the extent that the Company borrows funds specifically for the purpose of obtaining a qualifying asset, the Company determines the amount of borrowing costs eligible for capitalization as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. The Company immediately recognizes other borrowing costs as an expense. To the extent that the Company borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the Company determines the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the borrowings of the Company that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that the Company capitalizes during a period does not exceed the amount of borrowing costs incurred during that period.

(d) Government Grants

Government grants are not recognized unless there is reasonable assurance that the Company will comply with the grant's conditions and that the grant will be received. Government grants which are intended to compensate the Company for expenses incurred are recognized as other income in profit or loss over the periods in which the Company recognizes the related costs as expenses.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(e) Intangible Assets

Intangible assets are measured initially at cost and, subsequently, are carried at cost less accumulated amortization and accumulated impairment losses. Intangible assets consist of industrial property rights, facility usage rights and intangible assets under development. 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 some of industrial property rights and facility usage 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:

	Useful lives (years)
Industrial property rights	10 ~ 20 or indefinite
Facility usage rights	indefinite
Intangible assets under development	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 estimate.

(f) Investment Property

Property held for the purpose of earning rentals or benefiting from capital appreciation is classified as investment property. Investment property is initially measured at its cost. Transaction costs are included in the initial measurement. Subsequently, investment property is carried at depreciated cost less any accumulated impairment losses.

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

Investment property except for land, are depreciated on a straight-line basis over 10 ~ 60 years as estimated useful lives.

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

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(g) Non-current Assets Held for Sale

Non-current assets, or disposal groups comprising assets and liabilities, that are expected to be recovered primarily through sale rather than through continuing use, are classified as held for sale. In order to be classified as held for sale, the asset (or disposal group) must be available for immediate sale in its present condition and its sale must be highly probable. The assets or disposal group that are classified as non-current assets held for sale are measured at the lower of their carrying amount and fair value less cost to sell.

The Company recognizes an impairment loss for any initial or subsequent write-down of an asset (or disposal group) to fair value less costs to sell, and a gain for any subsequent increase in fair value less costs to sell, up to the cumulative impairment loss previously recognized in accordance with K-IFRS No. 1036 *Impairment of Assets*. However, deferred income tax assets, assets generated from employees' salaries, and financial assets covered by the K-IFRS No. 1039 *Financial Instruments : Recognition and measurement* are measured according to the relevant criteria sheet.

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

(h) Inventories

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

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

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

Tobacco leaf inventories which have an operating cycle that exceeds 12 months are classified as current assets, consistent with recognized industry practice. The estimated amounts of inventories in current assets which are not expected to be consumed within 12 months are ₩302,903 million and ₩314,457 million, respectively, as of December 31, 2017 and December 31, 2016.

(i) Impairment of Non-financial Assets

The carrying amounts of the Company's non-financial assets, other than inventories, deferred tax assets, assets arising from employee benefits and non-current assets held for sale, are reviewed at the end of the reporting period to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. Goodwill and intangible assets that have indefinite useful lives or that are not yet available for use, irrespective of whether there is any indication of impairment, are tested for impairment annually by comparing their recoverable amount to their carrying amount.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(i) Impairment of Non-financial Assets, Continued

The Company estimates the recoverable amount of an individual asset. If it is impossible to measure the individual recoverable amount of an asset, then the Company estimates the recoverable amount of cash-generating unit ("CGU"). A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. The recoverable amount of an asset or CGU is the greater of its value in use and its fair value less costs to sell. The value in use is estimated by applying a pre-tax discount rate that reflect current market assessments of the time value of money and the risks specific to the asset or CGU for which estimated future cash flows have not been adjusted, to the estimated future cash flows expected to be generated by the asset or CGU.

An impairment loss is recognized if the carrying amount of an asset or a CGU exceeds its recoverable amount. Impairment losses are recognized in profit or loss.

(j) Non-derivative Financial Assets

The Company recognizes and measures non-derivative financial assets by the following four categories: financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables and available-for-sale financial assets. The Company recognizes financial assets in the statement of financial position when the Company becomes a party to the contractual provisions of the instrument.

Upon initial recognition, non-derivative financial assets are measured at their fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the asset's acquisition or issuance.

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

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

(ii) Held-to-maturity investments

A non-derivative financial asset with a fixed or determinable payment and fixed maturity, for which the Company has the positive intention and ability to hold to maturity, are classified as held-to-maturity investments. Subsequent to initial recognition, held-to-maturity investments are measured at amortized cost using the effective interest method.

(iii) Loans and receivables

Loans and receivables are financial assets with fixed or determinable payments that are not quoted in an active market. Subsequent to initial recognition, loans and receivables are measured at amortized cost using the effective interest method except for loans and receivables of which the effect of discounting is immaterial.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(j) Non-derivative Financial Assets, Continued

(iv) Available-for-sale financial assets

Available-for-sale financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified as financial assets at fair value through profit or loss, held-to-maturity investments or loans and receivables. Subsequent to initial recognition, they are measured at fair value, which changes in fair value, net of any tax effect, recorded in other comprehensive income in equity. Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments are measured at cost.

(v) De-recognition of financial assets

The Company derecognizes a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Company is recognized as a separate asset or liability.

If the Company retains substantially all the risks and rewards of ownership of the transferred financial assets, the Company continues to recognize the transferred financial assets and recognizes financial liabilities for the consideration received.

(vi) Offsetting between financial assets and financial liabilities

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

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(I) Impairment of Financial Assets

A financial asset not carried at fair value through profit or loss is assessed at each reporting date to determine whether there is objective evidence that it is impaired. A financial asset is impaired if objective evidence indicates that a loss event has occurred after the initial recognition of the asset, and that the loss event had a negative effect on the estimated future cash flows of that asset that can be estimated reliably. However, losses expected as a result of future events, regardless of likelihood, are not recognized.

If financial assets have objective evidence that they are impaired, impairment losses should be measured and recognized.

(i) Financial assets measured at amortized cost

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of its estimated future cash flows discounted at the asset's original effective interest rate. If it is not practicable to obtain the instrument's estimated future cash flows, impairment losses would be measured by using prices from any observable current market transactions. The Company can recognize impairment losses directly or establish a provision to cover impairment losses. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed either directly or by adjusting an allowance account.

(ii) Financial assets carried at cost

If there is objective evidence that an impairment loss has occurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses are not reversed.

(iii) Available-for-sale financial assets

When a decline in the fair value of an available-for-sale financial asset has been recognized in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized in other comprehensive income is reclassified from other comprehensive income to profit or loss as a reclassification adjustment even though the financial asset has not been derecognized. Impairment losses recognized in profit or loss for an investment in an equity instrument classified as available-for-sale are not reversed through profit or loss. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in profit or loss, the impairment loss is reversed, with the amount of the reversal recognized in profit or loss. For an investment in an equity security, objective evidence of impairment includes a significant or prolonged decline in its fair value below its cost. The Company considers a decline of 20% to be significant and a period of nine months to be prolonged.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(m) Cash and Cash Equivalents

Cash and cash equivalents comprise cash balances and call deposits with maturities of three months or less from the acquisition date that are subject to an insignificant risk of changes in their fair value, and are used by the Company in the management of its short-term commitments. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares when it has a short maturity with a specified redemption date.

(n) Non-derivative Financial Liabilities

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

(i) Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss include financial liabilities held for trading or designated as such upon initial recognition. Subsequent to initial recognition, financial liabilities at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss. Upon initial recognition, transaction costs that are directly attributable to the acquisition are recognized in profit or loss as incurred.

(ii) Financial guarantee liabilities

Financial guarantee liability is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified term of a debt instrument. Upon initial recognition, financial guarantee liabilities are measured at their fair value plus, transaction costs that are directly attributable to the acquisition or issue of the financial guarantee liability.

After initial recognition, an issuer of such a contract measures it at the higher of the amount determined in accordance with K-IFRS No. 1037 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognized less, when appropriate, cumulative amortisation recognized in accordance with K-IFRS No. 1018 *Revenue*.

(iii) Other financial liabilities

Non-derivative financial liabilities other than financial liabilities at fair value through profit or loss or financial guarantee liabilities are classified as other financial liabilities. At the date of initial recognition, other financial liabilities are measured at fair value minus transaction costs that are directly attributable to the acquisition. Subsequent to initial recognition, other financial liabilities are measured at amortized cost using the effective interest method.

The Company derecognizes a financial liability from the statement of financial position when it is extinguished (i.e. when the obligation specified in the contract is discharged, cancelled or expires).

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(o) Employee Benefits

(i) Short-term employee benefits

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

(ii) Retirement benefits: defined contribution plans

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

(iii) Retirement benefits: defined benefit plans

The calculation of defined benefit obligations is performed annually by a qualified actuary using the projected unit credit method. When the calculation results in a potential asset for the Company, the recognized asset is limited to the present value of economic benefits available in the form of any future refunds from the plan or reductions in future contributions to the plan. To calculate the present value of economic benefits, consideration is given to any applicable minimum funding requirements.

Remeasurements of the net defined benefit liability, which comprise actuarial gains and losses, the return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognized immediately in other comprehensive income. The Company determines the net interest expense (income) on the net defined benefit liability (asset) for the year by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then-net defined benefit liability (asset), taking into account any changes in the net defined benefit liability (asset) during the period as a result of contributions and benefit payments. Net interest expense and other expenses related to defined benefit plans are recognized in profit or loss.

When the benefits of a plan are changed or when a plan is curtailed, the resulting change in benefit that relates to past service or the gain or loss on curtailment is recognized immediately in profit or loss. The Company recognizes gains and losses on the settlement of a defined benefit plan when the settlement occurs.

(iv) Termination benefits

Termination benefits are expensed at the earlier of when the Company can no longer withdraw the offer of those benefits and when the Company recognizes costs for a restructuring. If benefits are not expected to be settled wholly within 12 months of the end of the reporting period, they are discounted.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(p) Provisions

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

The risks and uncertainties that inevitably surround many events and circumstances are taken into account in reaching the best estimate of a provision. Where the effect of the time value of money is material, provisions are determined at the present value of the expected future cash flows.

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

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

(q) Equity Capital

Ordinary shares are classified as equity. Incremental costs directly attributable to the issuance of ordinary shares and share options are recognized as a deduction from equity, net of any tax effects.

When the Company repurchases its share capital, the amount of the consideration paid is recognized as a deduction from equity and classified as treasury shares. The profits or losses from the purchase, disposal, reissue, or retirement of treasury shares are not recognized as current profit or loss. If the Company acquires and retains treasury shares, the consideration paid or received is directly recognized in equity.

(r) Revenue Recognition

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

Revenue from sales of goods is measured at the fair value of the consideration received or receivable, net of tobacco excise and other taxes, trade discounts and volume rebates. Revenue from the sale of goods is recognized when the Company has transferred to the buyer the significant risks and rewards of ownership of the goods, the Company retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Company and the costs incurred or to be incurred in respect of the transaction can be measured reliably. Tobacco excise and other taxes deducted from revenue for the ended December 31, 2017 and 2016 were ₩ 5,897,095 million and ₩6,140,131 million, respectively.

The profit on the self-selling construction such as apartments is recognized according to the construction progress rate based on actual construction cost generation amount for total construction scheduled costs and the progress criteria considering the rate of sales when the revenue and progress can be reliably estimated, the economic benefits are likely to come in, and the costs incurred for completing the transaction are measured reliably.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(r) Revenue Recognition, continued

Meanwhile, the profits on the self-selling construction apartment are recognized as progress standard according to the reply by the Korea Accounting Institute, namely '2011-I- KQA'. This accounting standards is effective under K-IFRS.

The profits from the provision of services are recognized according to the progress when the revenue and progress can be measured reliably, the economic benefits can be introduced, and the costs incurred for completing the transaction can be reliably measured. However, if the performance of the service provision transaction can not be reliably estimated, only the amount within the recoverable costs recognized is recognized as a profit.

The profits from investment properties are recognized on a fixed basis over the lease period.

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 completions is assessed by reference to surveys of work performed. Meanwhile, profits from an apartment house for self-instalment sales is recognized on percentage-of-completion method according to Q&A of Korea Accounting Institute, namely 2011-I-KQA. This accounting treatment is valid only under the K-IFRS as stated in subclause1 of clause 1, Article 13 of *the Act on External Audit of Stock companies*.

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 Company, the stage of completion of the transaction at the end of the reporting period can be measured reliably and the costs incurred for the transaction and the costs to complete the transaction can be measured reliably. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue is recognized only to the extent of the expenses recognized that are recoverable.

Rental income from investment property, net of lease incentives granted, is recognized in profit or loss on a straight-line basis over the term of the lease.

(s) Finance Income and Finance Costs

Finance income comprises interest income on funds invested (including available-for-sale financial assets), dividend income and investment income on long-term deposits in MSA Escrow Fund. Interest income is recognized as it accrues in profit or loss, using the effective interest method. Dividend income is recognized in profit or loss on the date that the Company's right to receive payment is established.

Finance costs is interest expense on unwinding of the discount on trade and other payables which is recognized in profit or loss using the effective interest method.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(t) Income Taxes

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

(i) Current tax

Current tax is the expected tax payable or receivable on the taxable profit or loss for the year, using tax rates enacted or substantively enacted at the end of the reporting period and any adjustment to tax payable in respect of previous years. The taxable profit is different from the accounting profit for the year since the taxable profit is calculated excluding the temporary differences, which will be taxable or deductible in determining taxable profit (tax loss) of future periods, and non-taxable or non-deductible items from the accounting profit.

(ii) Deferred tax

The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities. The Company recognizes a deferred tax asset for all deductible temporary differences to the extent that it is probable that the temporary difference will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilized.

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

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period to recover or settle the carrying amount of its assets and liabilities.

Deferred tax assets and liabilities are offset only if there is a legally enforceable right to offset the related current tax liabilities and assets, and they relate to income taxes levied by the same tax authority and they intend to settle current tax liabilities and assets on a net basis

(u) Foreign Currencies

Transactions in foreign currencies are translated to the respective functional currencies of the Company at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated to the functional currency using the reporting date's exchange rate. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated to the functional currency at the exchange rate at the date that the fair value was determined.

Foreign currency differences arising on retranslation are recognized in profit or loss, except for differences arising on the retranslation of available-for-sale equity instruments, a financial liability designated as a hedge of the net investment in a foreign operation, or qualifying cash flow hedges, which are recognized in other comprehensive income. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(v) Earnings per Share

The Company presents basic and diluted earnings per share ("EPS") data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period, adjusted for own shares held. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding, adjusted for own shares held, for the effects of all dilutive potential ordinary shares.

(w) Operating Segment

An operating segment is a component of the Company that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Company's other components. All operating segments' operating results are reviewed regularly by the Company's chief executive officer to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available.

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

(x) Emissions rights

The Company accounts for greenhouse gases emission right and the relevant liability as below pursuant to the Act on Allocation and Trading of Greenhouse Gas Emission which became effective in 2015.

(i) Greenhouse Gases Emission Right

Greenhouse Gases Emission Right consists of emission allowances which are allocated from the government free of charge or purchased from the market. The cost includes any directly attributable costs incurred during the normal course of business. Emission rights held for the purpose of performing the obligation is classified as intangible asset and is initially measured at cost and after initial recognition, are carried at cost less accumulated impairment losses. Emission rights held for short-swing profits are classified as current asset and are measured at fair value with any changes in fair value recognized as profit or loss in the respective reporting period. The Company derecognizes an emission right asset when the emission allowance is unusable, disposed or submitted to government in which the future economic benefits are no longer expected to be probable.

(ii) Emission liability

Emission liability is a present obligation of submitting emission rights to the government with regard to emission of greenhouse gas. Emission liability is recognized when it is probable that outflows of resources will be required to settle the obligation and the costs required to perform the obligation are reliably estimable. Emission liability is an amount of estimated obligations for emission rights to be submitted to the government for the performing period. The emission liability is measured based on the expected quantity of emission for the performing period in excess of emission allowance in possession and the unit price for such emission rights in the market at the end of the reporting period.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(y) New Standards and Interpretations Not Yet Adopted

The following new standards are effective and earlier application is permitted; however, the Company has not early adopted the following new standards and interpretations in preparing these separate financial statements.

- K-IFRS No. 1109 *Financial Instruments*

K-IFRS No. 1109 'Financial instruments', published on September 25, 2015, is effective for annual periods beginning on or after January 1, 2018, with early adoption permitted. It replaces the existing standard in K-IFRS No. 1039 'Financial Instruments: Recognition and Measurement'. The Company plans to adopt the new standard in preparing consolidated financial statements on January 1, 2018. The Company will apply K-IFRS No. 1109 from the beginning of the fiscal year beginning on January 1, 2018, with the cumulative effect of the adoption being recognized as adjustments to retained earnings as of January 1, 2018.

An entity should apply this standard retrospectively, is permitted not to restate financial statements regarding classification and measurement of financial instruments and impairments. An entity may apply the hedge accounting prospectively except for the time value of options and forward element of forward contracts.

K-IFRS No. 1109 includes guidance on the business model for managements of financial instrument and classification and measurement of financial instrument based on contractual cash flows, expected credit loss model of financial instruments, expansion of qualifying hedge instruments for hedge accounting and changes in evaluation method for hedge accounting.

Financial effect analysis, establishing policy and stabilizing system are generally required or smooth adoption of K-IFRS No. 1109. The effect on financial statements on initial date of adoption of this new standards may varies depending on selection and judgement of accounting policy and financial instruments held by the Company and economic situation.

The Company performed preliminary analysis for evaluating potential effects on financial statements of 2018 based on present situation and information available and the followings are expected potential effect on financial statements of 2018 with adoption of K-IFRS No. 1109. The Company plans to implement detailed analysis based on further information, and the results of preliminary analysis of potential effect on financial statements with adoption of K-IFRS 1109 may change upon obtaining additional information available to the Company in the future.

(i) Classification and measurement of financial instruments

The Company plans to classify financial instruments on the basis of business model for the management of financial instrument and contractual cash flows of financial instruments as categorized shown in the following table financial instruments measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss. And if a hybrid contract hosts a non-derivative financial instruments with embedded derivatives, the financial instrument is classified on the basis of the entire contract financial assets without separating.

Business model	Character of contractual cash flows	
	Principal and interests	Others
To collect contractual cash flows	Measured at amortised cost(*1)	Measured at fair value through profit or loss(*2)
Both collecting contractual cash flows and selling financial assets	Measured at fair value through other comprehensive income(*1)	Measured at fair value through profit or loss(*2)
Selling financial assets and others	Measured at fair value through profit or loss	Measured at fair value through profit or loss(*2)

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(y) New Standards and Interpretations Not Yet Adopted, Continued

- K-IFRS No. 1109 *Financial Instruments, continued*

(i) Classification and measurement of financial instruments, continued

(*1) It can be designated as fair value through profit or loss to eliminate or reduce inconsistency of accounting mismatch. (irrevocable)

(*2) It can be designated as fair value through other comprehensive income in case of short term trade equity irrevocably. (irrevocable)

Under K-IFRS No.1109, criteria for classification of financial instruments as at amortised cost and fair value through other comprehensive income are more stringent than K-IFRS No. 1039, volatilization in profit or loss may increase with adoption of K-IFRS No. 1109.

The carrying amount of loans and receivables and available-for-sale financial assets as of December 31, 2017 are ₩4,183,358 and ₩454,051 million.

In accordance with K-IFRS No.1109, Financial instruments with contractual cash flows consisted of solely principal and interests can be measured at amortised cost. The carrying amount of loans and receivables is ₩4,183,358 million and except ₩510,223 million, the Group measure ₩3,673,135 million at amortised cost.

Contractual cash flow of long-term deposits in MSA Escrow Fund accounted classified as loans and receivables amounting to ₩510,223 million is consisted of solely principal and interests. The effect of measurement of the financial instruments increases the amount of financial instruments measured at amortised cost by ₩11,048 million. As a result of these adjustments, the Company expects that retained earnings will be increased by ₩8,010 million as of January 1, 2018.

According to K-IFRS No. 1109, equity instruments that are not held for trading purposes are subject to irrevocable selection at initial recognition as measured at fair value through other comprehensive income-fair value measurement, the comprehensive income is not subsequently recycled to profit or loss. The amount of equity instruments in available-for-sale financial assets is ₩269,882 million as of December 31, 2017. Based on the preliminary impact assessment results, the Group plans to designate equity instruments as measured at fair value through other comprehensive income, with adoption of K-IFRS No. 1109, and the Company expects that there is no significant effect on financial statements

According to the preliminary impact assessment results, with adoption of K-IFRS No. 1109, beneficiary certificates amounting to ₩184,169 million classified as available-for-sale financial assets as of December 31, 2017 are expected to be measured at fair value through profit or loss and are to increase by ₩184,169 million. As a result, it is expected that the gain or loss on available-for-sale assets classified as reserve on January 1, 2018 will be reclassified to retained earnings by ₩3,895 million.

(ii) Classification and measurement of financial liability

With adoption of K-IFRS No. 1109, the change in the fair value of financial liabilities due to change in credit risk of financial liabilities designated as fair value through profit or loss is recognized in other comprehensive income, not in profit or loss, and it does not recirculate to subsequently profit or loss. When fair value changes due to changes in credit risk of financial liabilities are recognized in other comprehensive income, changes in fair value are recognized in profit or loss when accounting inconsistencies occur or expand.

The Group does not have any financial liabilities at fair value through profit or loss, as of December 31, 2017.

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Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(y) New Standards and Interpretations Not Yet Adopted, Continued

- K-IFRS No. 1109 *Financial Instruments, continued*

(iii) Impairment: Financial assets and contract assets

Under K-IFRS No. 1039, impairment loss is recognized only when there is objective evidence of an impairment according to an incurred loss model. However, K-IFRS No. 1109 requires financial instrument measured at amortized cost or debt instrument measured at fair value through other comprehensive income s, a lease receivable, a contract asset or a loan commitment and a loan guarantee contract to recognize impairment loss in accordance with the expected credit loss model.

In accordance with K-IFRS No. 1109, the loss allowance for financial assets should be measured by the amount corresponding to the 12-month expected credit loss or the total expected credit loss, divided into three levels according to the increase in credit risk after the first recognition of the financial asset. The credit loss can be recognized early compared to the incurred loss model of K-IFRS No. 1039.

Stage(*1)	Expected credit loss
Stage 1	When the credit risk is not increased significantly after initial recognition(*2)
Stage 2	When the credit risk increases significantly after initial recognition
Stage 3	When the credit is impaired

(*1) In the case of trade receivables or contract assets that are applied K-IFRS No. 1115 'Revenue from contracts with customers', the amount of loss allowance is measured at lifetime expected credit losses only if there is no significant financing component to be measured, an accounting policy can be chosen to measure the loss allowance with an amount equal to the lifetime expected credit loss over the period. Loss allowance for lease receivable can be measured with an amount equal to the lifetime expected credit loss over the period.

(*2) When the credit risk is low at the end of the reporting date, the credit risk may not be considered to have increased significantly.

Loss allowance for financial instrument with impaired credit when initial recognition is recognized cumulative change in life time expected credit loss after initial recognition.

The carrying amount of loans and receivables measured at amortized cost as of December 31, 2017 is ₩4,183,358 million and loss allowance for these assets is ₩56,925 million.

The preliminary result for measuring loss allowance for accounts receivables-trade, contract assets and lease receivables with significant financing component is measured at the amount corresponding to the lifetime expected credit loss for the period with simplified approach, the credit risk is not significantly increased when the credit risk is low at the end of the reporting period and the Company expects that loss allowance is increased by ₩78,420 from ₩56,925 as of January 1, 2018. As a result, the retained earnings as of January 1, 2018 are expected to decrease by ₩56,885 million.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(y) New Standards and Interpretations Not Yet Adopted, Continued

- K-IFRS No. 1115 '*Revenue from contracts with customers*'

Revenue from contractual arrangements with customers' is effective for the periods beginning on or after January 1, 2018, with early adoption permitted. The Standard is replacing the current IFRS 1018 'Revenue', No. 1011 'Construction Contract', 'Accounting Standard Interpretation No. 2031' Revenue: Exchange Transaction of Advertising Services', No. 2113 'Customer Loyalty Program' 'Real estate construction agreement', and No. 2118 'Transfer of assets from customers'. The Company will apply K-IFRS 1115 from the beginning of the fiscal year beginning on January 1, 2018 by recognizing the cumulative effect of the adoption being recognized as of January 1, 2018. The Company will also take the practical expedient by only evaluating contracts that are not completed as of January 1, 2018.

K-IFRS No. 1018, we provide revenue recognition standards for different types of transactions such as sales of goods, provision of services, interest income, royalty income, dividend income, and construction contracts. According to the new standard No. 1115, 5-step revenue recognition model is applied to all types of contracts.

① Identifying the contracts with the customer → ② Identifying the performance obligations in the contract
→ ③ Determining the transaction price → ④ Allocating the transaction price to the performance obligations
→ ⑤ Recognizing revenue when the performance obligation is satisfied

Based on the situation and available information as of December 31, 2017, the Company assessed the financial impact of the separated financial statements of the application of K-IFRS No. 1115 and the results are as follows. The results of the Company's impact assessment as of December 31, 2017, are subject to change based on additional information available to the Company in the future.

(i) Variable consideration

The Company offer discounts on certain contracts the Company have made with our customers. The Company recognizes revenue at the fair value of consideration received or receivable in light of the discounts provided. If the Company can not reliably measure its revenue, the Company deferred revenue recognition until the uncertainty is resolved. Such sale discounts are subject to variable costs in K-IFRS No.1115 and are estimated at the inception of the contract and must be reviewed subsequently.

In order to estimate the variable cost of a payment obligation, the Company are considering applying an expected value method or a method that better predicts the most likely amount of the variable cost. The Company has evaluated the requirements of Statement of Financial Accounting Standards No. 1115 for the Restriction on Variable Cost Estimates and expects there will be no decrease in revenue from the sale of goods in 2017.

(ii) Consideration Payable to a customer

The Company provide logistics expense, insurance expense, and credit card fees for some of the contracts with customers. The Company recognizes revenue at the fair value of the consideration received or receivable reflecting the logistics costs incurred. K-IFRS No.1115 requires that distinct goods or services be accounted for at the transaction price, in consideration of the consideration payable to the customer, unless the customer has paid the consideration for transferring the goods or services to the entity. As a result, logistics costs are recognized as a deduction for revenue when a subsequent the later event occurs, which is payable to the customer in accordance with K-IFRS No. 1115.

- the entity recognizes revenue for the transfer of the related goods or services to the customer;
- the entity pays or promises to pay the consideration (even if the payment is conditional on a future event).

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(y) New Standards and Interpretations Not Yet Adopted, Continued

- K-IFRS No. 1115 'Revenue from contracts with customers'

① Logistics costs

The Company provide shipping and handling services to customers according to contracts. In applying K-IFRS No. 1115, the Company expects to reduce income from sales of goods by ₩ 4,437 million and recognizes related accounts receivable amounting to ₩ 4,437 million in the statement of financial position. As a result of these adjustments, the retained earnings on January 1, 2018 are expected to decrease by ₩ 3,217 million.

② Insurance

The Company provide Insurance to customers based on contracts. In applying K-IFRS No. 1115, the Company expects to recognize related accounts payable of ₩ 204 million in the statement of financial position on the date of initial application. As a result of these adjustments, the retained earnings of January 1, 2018 are expected to decrease by ₩ 148 million.

③ Credit card fee

The Company pays the credit card fee for the sales according to the contract with the customer. In applying K-IFRS No. 1115, the Company expects to recognize the amount as a deduction from sales. As a result of these adjustments, the retained earnings on January 1, 2018 are expected to remain unchanged.

- K-IFRS No. 1116 'Lease'

K-IFRS No. 1116 'Lease' established on May 22, 2017 is effective for annual periods beginning on or after January 1, 2018, with early adoption permitted. It replaces existing lease standards, including K-IFRS No. 1017 'Lease', K-IFRS No. 2104 'Determining whether a commitment includes a lease', K-IFRS No. 2015 'Operating lease: incentive', K-IFRS No. 2027 'Assessment of the substance of the transaction, including lease in legal form'.

At the time of contract, the Company determines whether the contract is a lease or whether the contract includes a lease, and identifies whether the contract is a lease or whether the contract includes a lease, in accordance with this standard at the date of initial application. However, the Company may not re-judge all contracts by applying the simplified method for contracts before the first application date.

The lessee and the lessor must account for each lease element in the lease contract separately from the non-lease element (called "non-lease element") in the lease contract or the contract including lease.

The lessee must recognize a lease asset representing the right to use an underlying asset and a lease liability representing an obligation to pay the lease payments. However, short-term leases(Lease with lease period less than 12 month) and small leases are subject to the exemption provisions of the Standard. In addition, the lessee can use the simplified method as a method of accounting for each lease element and related non-lease element as one lease element instead of separating the non-lease element from the lease element.

The accounting for lessor didn't change significantly with the accounting of the current K-IFRS No. 1017.

The lessee can apply either the retrospective application for the past reporting period or retrospective application to recognize the cumulative effect of the initial application at the date of initial application, in accordance with K-IFRS No. 1008 'Accounting Policies, Changes in Accounting Estimates and Errors'.

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Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

3. Significant Accounting Policies, Continued

(y) New Standards and Interpretations Not Yet Adopted, Continued

- K-IFRS No. 1116 'Lease', continued

The Company currently plans to apply K-IFRS No. 1116 initially on January 1, 2019. The actual impact of adopting those new standard will be dependent on the lease asset that the Company holds and economic conditions at that time as well as accounting and judgements that the Company will make in the future. The Company did not assess the potential impact on policy selected its separate financial statements resulting from the application of those new standards and expects to disclose additional quantitative information before the Company adopts the Standard in 2018.

4. Basis of Translating Financial Statements

The separate financial statements are presented in Korean won and have been translated into U.S. dollars at the rate of ₩1,071.40 to \$1, the basic exchange rate on December 31, 2017 posted by Seoul Money Brokerage Services, solely for the convenience of the reader. This translation does not comply with K-IFRS and 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.

KT&G CORPORATION
Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

5. Property, Plant and Equipment

(a) Details of property, plant and equipment as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>	2017			2016		
	Cost	Accumulated depreciation	Carrying amount	Cost	Accumulated depreciation	Carrying amount
Land	549,343	-	549,343	426,463	-	426,463
Buildings	713,395	(356,312)	357,083	689,658	(335,706)	353,952
Structures	45,867	(32,937)	12,930	45,467	(30,987)	14,480
Machinery	986,214	(798,513)	187,701	1,023,827	(816,628)	207,199
Vehicles	1,791	(1,379)	412	2,293	(1,933)	360
Tools	34,827	(30,080)	4,747	39,406	(34,051)	5,355
Furniture and fixtures	134,394	(97,545)	36,849	166,700	(124,394)	42,306
Others	1,594	-	1,594	1,681	-	1,681
Construction-in-progress	117,166	-	117,166	65,472	-	65,472
	2,584,591	(1,316,766)	1,267,825	2,460,967	(1,343,699)	1,117,268

(b) Changes in property, plant and equipment for the years ended December 31, 2017 were as follows:

<i>In millions of won</i>	January 1 2017	Acquisition	Disposal	Deprecia- tion	Transfer of construction-in-progress	Transfer to investment property	December 31 2017
Land	₩ 426,463	4	(245)	-	123,369	(248)	549,343
Buildings	353,952	2,656	(332)	(25,392)	26,882	(683)	357,083
Structures	14,480	380	(47)	(2,003)	123	(3)	12,930
Machinery	207,199	5,499	(2,740)	(42,542)	20,285	-	187,701
Vehicles	360	236	(12)	(172)	-	-	412
Tools	5,355	1,468	(86)	(2,441)	451	-	4,747
Furniture and fixtures	42,306	12,054	(112)	(18,379)	980	-	36,849
Others	1,681	13	(100)	-	-	-	1,594
Construction-in-progress	65,472	223,784	-	-	(172,090)	-	117,166
	₩ 1,117,268	246,094	(3,674)	(90,929)	-	(934)	1,267,825

For the year ended December 31, 2017, land, buildings and structures with a carrying amount of ₩934 million were transferred to investment property.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

5. Property, Plant and Equipment, Continued

(c) Changes in property, plant and equipment for the years ended 2016 were as follows:

<i>In millions of won</i>		January 1 2016	Acquisition	Disposal	Depreciation	Transfer of construction- in-progress	Other changes	December 31 2016
Land	₩	467,590	184	(1,685)	-	62,071	(101,697)	426,463
Buildings		385,418	691	(1,336)	(26,772)	101,183	(105,232)	353,952
Structures		15,901	718	(11)	(2,147)	345	(326)	14,480
Machinery		215,984	1,871	(1,349)	(48,013)	38,706	-	207,199
Vehicles		356	339	(165)	(171)	1	-	360
Tools		5,554	1,431	(56)	(2,397)	823	-	5,355
Furniture and fixtures		33,509	24,676	(5,031)	(16,697)	5,849	-	42,306
Others		1,366	9	-	-	306	-	1,681
Construction-in-progress		183,954	90,838	-	-	(209,284)	(36)	65,472
	₩	1,309,632	120,757	(9,633)	(96,197)	-	(207,291)	1,117,268

For the year ended December 31, 2016, the Company received ₩289 million of government grant related with acquisition of buildings and furniture and fixtures.

For the year ended December 31, 2016, land, buildings and structures with a carrying amount of ₩207,255 million were transferred to investment property and construction-in-progress with a carrying amount of ₩36 million were transferred to intangible assets.

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Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

6. Intangible Assets

(a) Details of intangible assets as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017			2016		
		Cost	Accumulated amortization	Carrying amount	Cost	Accumulated amortization	Carrying amount
Industrial property rights	₩	8,696	(5,597)	3,099	7,718	(5,556)	2,162
Facility usage rights		23,845	(23)	23,822	24,914	(1,708)	23,206
Intangible assets under development		314	-	314	3,560	-	3,560
	₩	32,855	(5,620)	27,235	36,192	(7,264)	28,928

(b) Changes in intangible assets for the years ended December 31, 2017 were as follows:

<i>In millions of won</i>		January 1 2017	Acquisition	Disposal	Reversal of Impairment loss	Transfer from property, plant equipment	Amortization	December 31 2017
Industrial property rights	₩	2,162	226	(10)	-	762	(41)	3,099
Facility usage rights		23,206	1,300	(922)	595	(357)	-	23,822
Intangible assets under development		3,560	474	(2,958)	-	(762)	-	314
	₩	28,928	2,000	(3,890)	595	(357)	(41)	27,235

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

6. Intangible Assets, Continued

(c) Changes in intangible assets for the years ended December 31, 2016 were as follows:

<i>In millions of won</i>		January 1 2016	Acquisition	Disposal	Transfer from property, plant and equipment	Amortization	December 31 2016
Industrial property rights	₩	1,462	721	-	-	(21)	2,162
Facility usage rights		17,472	6,189	(491)	36	-	23,206
Intangible assets under development		3,560	-	-	-	-	3,560
	₩	22,494	6,910	(491)	36	(21)	28,928

(d) Research and development expenditures not capitalized for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Cost of sales	₩	150	492
Selling, general and administrative expenses		15,931	11,757
	₩	16,081	12,249

7. Investment Property

(a) Details of investment property as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>			2017 Carrying amount			2016 Carrying amount
	Cost	Accumulated depreciation		Cost	Accumulated depreciation	
Land	125,011	-	125,011	124,763	-	124,763
Buildings	280,302	(79,890)	200,412	279,520	(69,087)	210,433
	405,313	(79,890)	325,423	404,283	(69,087)	335,196

(b) Changes in investment property for the year ended December 31, 2017 and the year ended December 31, 2016 were as follows:

<i>In millions of won</i>			2017			2016
	Land	Buildings	Total	Land	Buildings	Total
Beginning balance	124,763	210,433	335,196	23,066	113,735	136,801
Depreciation	-	(10,707)	(10,707)	-	(8,860)	(8,860)
Transfer from property, plant and equipment	248	686	934	101,697	105,558	207,255
Ending balance	125,011	200,412	325,423	124,763	210,433	335,196

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

7. Investment Property, Continued

(c) The amounts recognized in profit or loss from investment property for the years periods ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Rental income	₩	45,505	38,263
Direct operating expense		(10,707)	(8,860)
	₩	34,798	29,403

(d) The carrying amount and the fair value of investment property as of December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>			2017		2016
		Fair value	Carrying amount	Fair value	Carrying amount
Land	₩	744,481	125,011	532,420	124,763
Buildings		291,122	200,412	227,030	210,433
	₩	1,035,603	325,423	759,450	335,196

The fair value of investment property was determined based on the yield capitalization method by external, independent valuers. The fair value measurement for all of the investment properties has been categorized as level 3 fair value based on the inputs to the valuation techniques used.

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For the years ended December 31, 2017 and 2016

8. Investments in Associates and Joint Ventures

(a) Investments in associates and joint ventures as of December 31, 2017 and 2016 are summarized as follows:

In millions of won

Company	Location	Principal operation	2017		2016	
			Percentage of ownership	Carrying amount	Percentage of ownership	Carrying amount
Lite Pharm Tech, Inc.	Korea	Manufacturing medical supplies	20.24%	1,830	20.24%	1,830
KVG REIT 1 Co., Ltd.	Korea	Renting real estate	-	-	29.67%	7,300
JR REIT V Co., Ltd.	Korea	Renting real estate	34.63%	5,600	34.63%	5,600
JR REIT VIII Co., Ltd.	Korea	Renting real estate	21.74%	10,000	21.74%	10,000
LSK Global Pharma Services Co., Ltd.	Korea	Researching and developing medicine	23.15%	-	23.15%	-
JR REIT X Co., Ltd.	Korea	Renting real estate	28.79%	9,500	28.79%	9,500
JR REIT XIII Co., Ltd.	Korea	Renting real estate	27.03%	5,000	27.03%	5,000
KB Gimpo Logistics CR REIT Co., Ltd. ^(*)	Korea	Renting real estate	12.00%	3,000	12.00%	3,000
KORAMCO Private REIT 50 Fund ^(*)	Korea	Renting real estate	84.21%	16,000	84.21%	16,000
Yong In Jung Sim Co., Ltd	Korea	Renting real estate	22.22%	1,000	-	-
				51,930		58,230

(*) KB Gimpo Logistics CR REIT Co., Ltd is classified as a joint venture since decisions about the significant financial and operating policy of the investee cannot be made without unanimous consent of the parties, holding 12% shares each, as the voting power of 76% shares held by the collective investment business entity is not entitled to have an impact on a resolution of the investee by the *Financial Investment Services and Capital Markets Act*.

(*) KORAMCO Private REIT 50 Fund is classified as a joint venture since decisions about the significant financial and operating policy of the investee cannot be made without unanimous consent of the parties that control the arrangement collectively.

In 2017, the Company recognized ₩19 million of gain on sale of investments in associates and joint ventures as KVG REIT 1 Co, Ltd. was liquidated.

In 2017, the Company made an investment of ₩1,000 million in Yong In Jung Sim Co., Ltd.

In 2016, the Company made an investment of ₩3,000 million and ₩16,000 million in KB Gimpo Logistics CR REIT Co., Ltd and KORAMCO Private REIT 50 Fund, respectively.

In 2016, the Company recognized ₩6,095 million of gain on sale of investments in associates and joint ventures as KOCREF REIT 17 Co., Ltd. was liquidated.

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For the years ended December 31, 2017 and 2016

9. Investments in Subsidiaries

(a) Investments in subsidiaries as of December 31, 2017 and 2016 are summarized as follows:

In millions of won

Company	Location	Principal operation	2017		2016	
			Percentage of ownership	Carrying amount	Percentage of ownership	Carrying amount
Korea Ginseng Corporation	Korea	Manufacturing and selling ginseng	100.00%	₩ 716,148	100.00%	₩ 716,148
Yungjin Pharm. Co., Ltd.	Korea	Manufacturing and selling pharmaceutical	52.45%	73,299	53.00%	66,355
Tae-a Industry Co., Ltd.	Korea	Manufacturing tobacco materials	100.00%	15,698	100.00%	15,698
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	Manufacturing and selling tobaccos	99.99%	12,741	99.99%	30,049
Korea Tabacos do Brasil Ltda.	Brazil	Processing leaf tobaccos	99.99%	2,891	99.99%	2,891
KT&G Pars	Iran	Manufacturing and selling tobaccos	99.99%	-	99.99%	-
KT&G Rus L.L.C.	Russia	Manufacturing and selling tobaccos	100.00%	110,297	100.00%	110,297
KT&G USA Corporation	USA	Selling tobaccos	100.00%	4,913	100.00%	4,913
Cosmococ Co., Ltd.	Korea	Manufacturing and selling cosmetics	98.56%	56,581	98.49%	98,093
Renzoluc Pte., Ltd. ^(*)	Singapore	Manufacturing and selling tobaccos	100.00%	148,834	100.00%	-
KT&G Life Sciences Corporation	Korea	Researching and developing medicine	-	-	34.03%	15,852
KGC Yebon Corporation	Korea	Manufacturing and selling medical herbs	100.00%	49,828	100.00%	49,828
K-Q HongKong I, Limited	HongKong	Manufacturing and selling ginseng	-	-	100.00%	17,761
PT KT&G Indonesia	Indonesia	Manufacturing and selling tobaccos	99.99%	1,240	99.99%	-
K&I HK Co., Ltd.	HongKong	Selling cosmetics	-	-	100.00%	11
K&I China Co., Ltd.	China	Selling cosmetics	-	-	100.00%	5,532
SangSang Stay, Inc.	Korea	Hotel	100.00%	14,261	100.00%	20,000
KT&G Global Rus L.L.C.	Russia	Selling tobaccos	100.00%	1,497	100.00%	1,497
			₩ 1,208,228		₩ 1,154,925	

(*) The Company's percentage of ownership, shown above, excludes redeemable convertible preferred shares. As of December 31, 2017, the Company's percentage of ownership would be 88.6%, if preferred shares are included.

For the year ended December 31, 2017, the Company invested ₩97,202 million in cash to acquire additional 25,641,958 shares of Renzoluc Pte and acquired additional 13,151,932 shares of Renzoluc Pte due to conversion of loans amounting to ₩47,489.

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9. Investments in Subsidiaries, Continued

For the year ended December 31, 2017, the Company made a capital contribution in-kind to Cosmocos Co., Ltd. by transferring its interest in K&I HK Co., Ltd. and K&I China Co., Ltd., increasing its ownership from 98.49% to 98.56%. The Company measured the additional interest in Cosmocos Co., Ltd. at the carrying amount of its investment in K&I HK Co., Ltd. and K&I China Co., Ltd., considering the transaction did not have a discernible effect on the Company's economics.

KT&G Life Sciences Corporation, a subsidiary of the Company was merged into Yungjin Pharm. Co., Ltd. as of January 13, 2017. For the year ended December 31, 2017, the Company recognized ₩8,908 million of loss on disposal of investments in subsidiaries to recognize the difference between consideration transferred for fair value of Yungjin Pharm. Co., Ltd.'s shares and book value of interests in KT&G Life Sciences Corporation.

For the year ended December 31, 2017, the Company recognized ₩37 million of loss on disposal of investments in subsidiaries as K-Q HongKong I, Limited was liquidated.

For the year ended December 31, 2016, the Company acquired ₩27,417 million of additional shares of Cosmocos Co., Ltd. as a result of the conversion of its redeemable convertible preferred shares, increasing its ownership from 97.73% to 98.49%.

For the year ended December 31, 2016, redeemable convertible preferred shares of KT&G Life Sciences Corporation were converted and the Company acquired ₩1,565 million of additional shares of the investee, decreasing its ownership interest to 34.03% from 73.94%. As of January 13, 2017, KT&G Life Sciences Corporation was merged into Yungjin Pharm. Co., Ltd.

For the year ended December 31, 2016, the Company made a capital contribution in-kind of its interest in KGC Life & Gin Co., Ltd. to Korea Ginseng Corporation and measured the additional interest in Korea Ginseng Corporation at the carrying amount of its investment in KGC Life & Gin Co., Ltd., considering the transaction did not have a discernible effect on the Company's economics.

For the year ended December 31, 2016, the Company established KT&G Global Rus L.L.C.

(b) Impairment Loss

The Company conducts a sign of damage review of its investment in subsidiaries. If signs of damage are found, the Company perform a damage testing by estimating recovery capacity.

As a result, the Company recognized ₩70,103 million of impairment loss on investment in subsidiaries to KT&G Tutun Mamulleri Sanayi ve Ticaret A.S., COSMOCOS Co., Ltd, SangSang Stay Inc. and ₩5,383 million of reversal of impairment loss on investment in subsidiaries to Renzoluc Pte.,Ltd., PT KT&G Indonesia.

When the Company perform a damage testing, its value in use was evaluated as recoverable amount. The main assumptions used in estimating recoverable amount reflects management's assessment of future trends in the industry and is based on internal and external historical data.

Gross profit rate	-17.99% ~ 24.45%
Permanent Growth	1%
Discount Rate(Weighted average cost of capital)	10.0% ~ 14.12%

Discount rate were estimated based on the Company's credit rating and capital structure and calculated based on the target debt ratio.

KT&G CORPORATION

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For the years ended December 31, 2017 and 2016

10. Available-for-sale Financial Assets

(a) Changes in available-for-sale financial assets for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	365,805	340,149
Acquisitions		89,613	31,000
Net changes in fair value		22,931	28,643
Disposals or reclassification		(24,298)	(33,987)
Ending balance	₩	454,051	365,805
Statement of financial position:			
Current	₩	-	1,500
Non-current		454,051	364,305
	₩	454,051	365,805

For the year ended December 31, 2017, the Company reclassified ₩2,054 million of investment in the debt security of LSK Global Pharma Services Co., Ltd., whose maturity has expired, to loans. The Company recognized ₩554 million of gain on sale of available-for-sale financial assets difference between the fair value and the carrying amount of the investment.

The Company has recognized ₩2,595 million of gain on sale of available-for-sale financial assets from the disposition of available-for-sale financial assets as part of the sale of RKA Private Equity Investment Trust No1.

The Company has received the remaining assets distributed according to the liquidation procedure in the KORIF Private Equity Investment Trust No.6.

For the year ended December 31, 2017, the Company recognized ₩18,523 million of impairment loss on its investment in an equity instrument of U&I Corporation as there was a significant and prolonged decline in the fair value below below its cost.

For the year ended December 31, 2016, the Company recognized ₩13,988 million of gain on sale of available-for-sale financial assets upon liquidation of Mastern 2 REIT Co., Ltd.

For the year ended December 31, 2016, the Company recognized ₩4,077 million of impairment loss on its investment in an equity instrument of Rexahn Pharmaceuticals, Inc. as there was a significant and prolonged decline in the fair value below its cost.

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10. Available-for-sale Financial Assets, Continued

(b) Available-for-sale financial assets as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017	2016
Available-for-sale debt instruments:			
Corporate bonds	₩	-	1,500
Available-for-sale equity instruments:			
Listed			
– Oscotech, Inc.		8,686	3,775
– Shinhan Financial Group Co., Ltd.		198,013	181,378
– Rexahn Pharmaceuticals, Inc.		1,382	1,081
– U&I Corporation		12,079	14,060
		220,160	200,294
Unlisted		233,891	164,011
Total available-for-sale equity instruments		454,051	364,305
Total available-for-sale financial assets	₩	454,051	365,805

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

As of December 31, 2017 and 2016, ₩49,722 million and ₩32,555 million of available-for-sale financial assets that do not have a market price in an active market and whose fair value cannot be reliably measured are measured at cost, respectively.

11. Long-term Deposits in MSA Escrow Fund

Long-term deposits in MSA Escrow Fund as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017	2016
Demand deposits	₩	1,921	-
MMF		-	56,069
Treasury bill		-	21,559
Treasury note		508,302	425,964
	₩	510,223	503,592

As discussed in note 33 to the separate 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. For the years ended December 31, 2017 and 2016, ₩72,040 million and ₩89,663 million were paid into long-term deposits in MSA Escrow Fund, respectively.

Long-term deposits in MSA Escrow Fund are invested in demand deposits of financial institutions or government and public bonds. For the years ended December 31, 2017 and 2016, the Company recognized ₩2,547 million of investment income and ₩3,721 million of investment loss on long-term deposits in MSA Escrow Fund, respectively.

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Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

12. Trade and Other Receivables

(a) Trade and other receivables as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017		2016	
		Current	Non-current	Current	Non-current
Loans to employees	₩	17,048	35,931	16,687	38,853
Loans		7,982	21,978	55,644	4,230
Other receivables		26,467	5,789	104,677	4,568
Guarantee deposits		27,852	16,837	22,121	20,366
Accrued income		10,361	-	10,384	-
Trade receivables		861,725	-	931,085	-
	₩	951,435	80,535	1,140,598	68,017

(b) Trade and other receivables as of December 31, 2017 and 2016 have been reported in the separate statements of financial position net of allowances as follows:

<i>In millions of won</i>		2017		2016	
		Current	Non-current	Current	Non-current
Gross trade and other receivables	₩	996,982	91,913	1,200,737	79,643
Allowance:					
Loans		-	(11,378)	(24,194)	(11,626)
Other receivables		(11,346)	-	(11,459)	-
Accrued income		(2,072)	-	(2,333)	-
Trade receivables		(32,129)	-	(22,153)	-
		(45,547)	(11,378)	(60,139)	(11,626)
Net trade and other receivables	₩	951,435	80,535	1,140,598	68,017

(c) Changes in the allowance account for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	71,765	46,186
Impairment loss		9,976	27,331
Reversal of impairment loss		(24,816)	(1,752)
Ending balance	₩	56,925	71,765

Impairment loss (reversal of impairment loss) on trade and other receivables is included as part of selling, general and administrative expenses and other expense (income) in the separate statements of comprehensive income.

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Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

12. Trade and Other Receivables, Continued

(d) The aging schedule of trade and other receivables which were past due but not impaired as of December 31, 2017 and 2016 is as follows:

<i>In millions of won</i>		2017	2016
Within 1 month	₩	45,888	43,957
Between 1 and 2 months		36,653	52,048
Beyond 2 months		209,651	257,877
	₩	292,192	353,882

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

(e) Details of trade and other receivables that are measured at amortized cost as of December 31, 2017 and 2016 were as follows:

		2017			2016	
<i>In millions of won</i>	Effective interest rate	Current	Non-current	Effective interest rate	Current	Non-current
Loans to employees	1.89~5.68%	₩17,048	35,931	1.89~5.68%	₩16,687	38,853
Guarantee deposits	1.78~5.68%	27,852	16,837	1.78~5.68%	22,121	20,366
		₩44,900	52,768		₩38,808	59,219

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13. Inventories

(a) Inventories as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>	2017			2016		
	Acquisition price	Valuation allowance	Carrying Amount	Acquisition price	Valuation allowance	Carrying Amount
Goods	₩ 981	-	981	₩ -	-	-
Finished goods, net of loss on writedown of inventories	57,801	(833)	56,968	70,183	(769)	69,414
Work-in-progress	18,759	-	18,759	17,167	-	17,167
Raw materials	716,034	-	716,034	724,281	-	724,281
Supplies	23,176	-	23,176	28,429	-	28,429
By-products	5,591	-	5,591	6,041	-	6,041
Buildings under construction	-	-	-	699	-	699
Sites for lotting-out construction	-	-	-	12,985	-	12,985
Goods-in-transit	50,576	-	50,576	55,686	-	55,686
	₩ 872,918	(833)	872,085	₩ 915,471	(769)	914,702

(b) The amount of inventories recognized as an expense for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>	2017	2016
Cost of sales:		
Write-down (reversal of write-down) of inventories	₩ 64	728
Loss on retirement of inventories	2,872	4,255
Other expense:		
Loss on retirement of inventories	1,040	2,002
	₩ 3,976	6,985

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14. Cash and Cash Equivalents and Other Financial Assets

(a) Cash and cash equivalents as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017	2016
Cash on hand	₩	705	1,095
Demand deposits		104,120	77,640
Short-term investment assets		1,000,000	610,000
	₩	1,104,825	688,735

(b) Other financial assets as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017		2016	
		Current	Non-current	Current	Non-current
Time deposits	₩	100,000	6,340	100,000	-
Money trust		1,400,000	-	1,480,000	-
Certificates of deposit		30,000	-	40,000	-
	₩	1,530,000	6,340	1,620,000	-

(c) Financial assets restricted in use as of December 31, 2017 were as follows:

<i>In millions of won</i>		2017	2016
Other financial assets	₩	6,340	-

15. Non-current Assets Held for Sale

Changes in non-current assets held for sale for the years period ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	-	1,542
Disposal		-	(1,542)
Ending balance	₩	-	-

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16. Pledged Assets

(a) Investment property pledged as collateral as of December 31, 2017 was as follows:

In millions of won

Asset	Carrying amount	Type	Received amount	Collateralized amount	Secured party
Investment property	₩ 149,892	Leasehold deposits received	₩ 12,982	13,889	MetLife Insurance Korea Co., Ltd. and others
Other financial assets	6,340	Performance guarantee	-	6,340	Korea Land and Housing Corporation
Property, plant and equipment	24,601	Right to collateral security/ Right to lease on a deposit basis	3,104	3,493	Labor Welfare Corporation and others
	₩ 180,833		₩ 16,086	23,722	

(b) Investment property pledged as collateral as of December 31, 2016 was as follows:

In millions of won

Asset	Carrying amount	Type	Received amount	Collateralized amount	Leaseholder
Investment property	₩ 8,810	Leasehold deposits received	₩ 9,241	9,467	MetLife Insurance Korea Co., Ltd. and others

17. Share Capital and Other Capital Surplus

(a) Details of share capital as of December 31, 2017 and 2016 were as follows:

	2017	2016
Number of ordinary shares:		
Authorized	800,000,000	800,000,000
Issued	137,292,497	137,292,497
Outstanding	126,265,127	126,265,127
Par value in won	₩ 5,000	5,000
Share capital(In millions of won)	954,959	954,959

The Company has 53,699,400 shares of treasury shares reacquired and retired in prior years. Accordingly, as of December 31, 2017, the Company's ordinary share differs from the aggregate par value of issued shares by ₩268,497 million.

(b) Changes in the number of shares for the years ended December 31, 2017 and 2016 were as follows:

	2017			2016		
Number of share	Ordinary shares	Treasury shares	Total	Ordinary shares	Treasury shares	Total
Beginning balance	137,292,497	(11,027,370)	126,265,127	137,292,497	(11,326,605)	125,965,892
Donation of treasury shares	-	-	-	-	299,235	299,235
Ending balance	137,292,497	(11,027,370)	126,265,127	137,292,497	(11,027,370)	126,265,127

(c) There was no change in other capital surplus for the years ended December 31, 2017 and 2016.

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18. Treasury Shares and Gain on sales of Treasury shares

(a) Changes in treasury shares for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won, except number of shares</i>	2017		2016	
	Number of shares	Carrying amount	Number of shares	Carrying amount
Beginning balance	11,027,370 ₩	328,157	11,326,605 ₩	337,062
Donation of treasury shares	-	-	(299,235)	(8,905)
Ending balance	11,027,370 ₩	328,157	11,027,370 ₩	328,157

(b) Changes in gain on sales of treasury shares for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>	2017	2016
Beginning balance	₩ 513,776	494,648
Donation of treasury shares, net of tax	-	19,128
Ending balance	₩ 513,776	513,776

19. Reserves

(a) Details of reserves as of December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>	2017	2016
Available-for-sale financial assets - net change in fair value	₩ (1,812)	(30,929)
Legal reserve	602,937	602,937
Voluntary reserve	4,408,176	3,794,260
	₩ 5,009,301	4,366,268

(b) Available-for-sale financial assets - net change in fair value as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>	2017	2016
Available-for-sale financial assets - net change in fair value before tax	₩ (2,499)	(40,804)
Tax effect	687	9,875
	₩ (1,812)	(30,929)

(c) Legal Reserve

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

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19. Reserves, Continued

(d) Details of voluntary reserve as of December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Reserve for business rationalization	₩	12,851	12,851
Reserve for research and human resource development		10,000	20,000
Reserve for business expansion		698,881	698,881
Unconditional reserve		3,686,444	3,062,528
	₩	4,408,176	3,794,260

Reserve for business rationalization

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

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

Reserve for research and human resource development

According to *the Restriction of Special Taxation Act*, certain taxable deductions are required to be transferred from retained earnings to reserve for research and human resource development. This reserve may be used for each purpose and their remaining amounts could be reclassified as a voluntary reserve.

Reserve for business expansion and other reserves

The Company appropriated reserves without specific purposes. Those reserves can be used for other purposes upon a resolution at a general meeting of shareholders.

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20. Retained Earnings

(a) Changes in retained earnings for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	1,068,469	995,886
Dividends		(454,554)	(428,284)
Transfer from reserve for research and human resource development		10,000	10,000
Transfer to unconditional reserve		(623,915)	(577,602)
Profit for the period		974,896	1,087,347
Remeasurements of net defined benefit liability, net of tax		(15,200)	(18,878)
Ending balance	₩	990,096	1,068,469

(b) Statements of appropriation of retained earnings of the Parent Company for the years ended December 31, 2017 and 2016 are as follows:

Date of appropriation for 2017: March 16, 2018

Date of appropriation for 2016: March 17, 2017

<i>In millions of won</i>		2017	2016
Unappropriated retained earnings:		990,096	1,068,469
Beginning balance	₩	-	-
Profit for the year		974,896	1,087,347
Remeasurements of net defined benefit liability, net of tax		15,200	(18,878)
		990,096	1,068,469
Transfer from voluntary reserves		10,000	10,000
Unappropriated retained earnings available for appropriation		1,000,096	1,078,469
Appropriation of retained earnings:			
Dividends		(505,061)	(454,554)
Unconditional reserve		(495,035)	(623,915)
		(1,000,096)	(1,078,469)
Unappropriated retained earnings to be carried over to subsequent year	₩	-	-

21. Dividend

Dividends were declared and paid by the Company for the years ended December 31, 2017 and 2016 as follows:

		2017	2016
Dividends in millions of won	₩	454,554	428,284
Dividends per share in won		3,600	3,400
Dividend rate as a percentage of par value		72.00%	68.00%

Dividends of ₩505,061 million (₩4,000 per share) will be proposed at the shareholders' meeting to be held on March 16, 2018. The dividends have not been recognized as liabilities in the separate financial statements.

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22. Trade and Other Payables

Trade and other payables as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017		2016	
		Current	Non-current	Current	Non-current
Leasehold deposits received	₩	23,189	9,565	21,418	6,848
Trade payables		34,293	-	67,961	-
Withholdings		4,336	-	3,802	-
Withholdings value added tax		148,065	-	186,347	-
Accrued expenses		129,083	12,090	123,401	-
Other payables		47,621	-	33,341	-
	₩	386,587	21,655	436,270	6,848

23. Short-term Borrowings

Short-term borrowings as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>	Annual interest rate		2017	2016
Customer credit contracts:				
Nonghyup Bank	5.92%	₩	1,660	3,179
KEB Hana Card Co., Ltd.	3M CD rate+2.5%		299	672
		₩	1,959	3,851

24. Provision

Provisions as of December 31, 2017 and 2016 are as follow:

<i>In millions of won</i>		2017	2016
Basis	₩	-	-
Increase		3,086	-
Ending	₩	3,086	-

In the case of returnable sales, the Company estimate the amount of return capability expected at the time of sale and deducts the expected amount of return from sales to establish a debt to cover the returns. In addition, the costs incurred in relation to returns are reflected in the related provisions.

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25. Retirement Benefits Plan

(a) The components of retirement benefits for years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Defined benefit plans:			
Current service cost	₩	26,696	24,899
Net interest cost		943	928
		27,639	25,827
Defined contribution plans:			
Contributions recognized as expense		6,465	5,512
Remeasurement factor		12,090	-
	₩	46,194	31,339

The Company recognized termination benefits amounting to ₩2,426 as an expense for the years ended December 31, 2017.

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25. Retirement Benefits Plan, Continued

(b) Changes in net defined benefit liability for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	47,121	42,174
Current service cost		26,696	24,899
Net interest on net defined benefit liability		943	928
Remeasurements of net defined benefit liability before tax		(16,114)	24,905
Retirement benefits paid		(1,562)	(2,785)
Contributions to plan assets		(38,000)	(43,000)
Ending balance	₩	19,084	47,121
Statement of financial position:			
Present value of defined benefit obligations	₩	283,055	278,612
Fair value of plan assets		(263,971)	(231,491)
Net defined benefit liability	₩	19,084	47,121

(c) Changes in defined benefit obligations for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	278,612	247,774
Current service cost		26,696	24,899
Interest expense		5,399	5,261
Actuarial losses (gains) before tax		(16,555)	24,795
Retirement benefits paid		(11,097)	(24,117)
Ending balance	₩	283,055	278,612

(d) Changes in plan assets for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	231,491	205,600
Interest income		4,456	4,333
Return on plan assets, excluding interest income on plan assets		(441)	(110)
Retirement benefits paid		(9,535)	(21,332)
Contributions to plan assets		38,000	43,000
Ending balance	₩	263,971	231,491

Actual returns on plan assets were ₩4,015 million and ₩4,223 million for the years ended December 31, 2017 and 2016, respectively.

(e) Changes in plan assets for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	-	-
Remeasurement factor		12,090	-
Ending balance	₩	12,090	-

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25. Retirement Benefits Plan, Continued

(f) Details of remeasurements of net defined benefit liability in other comprehensive income for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Actuarial gains (losses) before tax:			
Financial assumptions	₩	21,475	(16,272)
Experience adjustments		(4,920)	(8,523)
Return on plan assets, excluding interest income on plan assets		(441)	(110)
Remeasurements of net defined benefit liabilities before tax		16,114	(24,905)
Tax effect		(914)	6,027
Remeasurements of net defined benefit liabilities, net of tax	₩	15,200	(18,878)

(g) The components of plan assets as of December 31, 2017 and 2016 are as follows:

<i>In millions of won</i>		2017	2016
Deposits, cash and cash equivalents	₩	1	21,141
Others		263,970	210,350
	₩	263,971	231,491

(h) The principal actuarial assumptions as of December 31, 2017 and 2016 are as follows:

	2017	2016
Discount rate	2.85%	2.00%
Rate of salary increase	4.50%	4.50%

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

As of December 31, 2017 and 2016, the weighted average duration of the defined benefit obligations was 8.71 years and 8.19 years, respectively.

(i) The effects of changes in each significant actuarial assumptions on defined benefit obligations as of December 31, 2017 would be as follows:

<i>In millions of won</i>		1% point increase	1% point decrease
Discount rate	₩	(22,313)	25,576
Salary increase rate		24,921	(22,204)

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26. Revenue from Real Estate Sales

(a) Details of agreements for real estate sales under construction as of December 31, 2017 were as follows:

<i>In millions of won</i>	<i>Construction period</i>		<i>Total revenue estimated</i>	<i>Total revenue contracted</i>
Daegu Station Central-Xi	Dec. 2014 ~ Oct. 2017	₩	343,950	343,950

(b) Changes in the balance of contract amount for the years December 31, 2017 and the year ended December 31, 2016 were as follows:

<i>In millions of won</i>		<i>2017</i>	<i>2016</i>
Beginning balance	₩	133,491	246,340
Other changes		1,725	23,700
Revenue recognized		(135,216)	(136,549)
Ending balance	₩	-	133,491

(c) Recognized profits and related balances for agreements under construction as of December 31, 2017 were as follows:

<i>In millions of won</i>	<i>Stage of completion</i>		<i>Aggregate revenue recognized</i>	<i>Aggregate expenses recognized</i>	<i>Due from customers for contract work</i>
Daegu Station Central-Xi	100 %	₩	343,950	278,301	16,571

Due from customers for contract work is recognized as trade and other receivables in the separate financial statements.

(d) The effect of changes in the estimates of total revenue and total costs for the year ended December 31, 2017 was as follows:

<i>In millions of won</i>		<i>Changes in total revenue</i>	<i>Changes in total costs</i>	<i>Effect on profit before income tax</i>	<i>Changes in due from customers for contract work</i>
Daegu Station Central-Xi	₩	(8)	1,046	(1,054)	(1,054)

The total revenue and the total costs are estimated based on the information and circumstances available at the end of the reporting period and actual results may differ from these estimates.

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27. Result from Operating Activities

(a) Details of expenses classified by nature for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Changes in inventories	₩	42,617	(25,667)
Raw materials and consumables purchased		811,397	869,447
Salaries		347,459	344,810
Retirement and termination benefits		34,104	33,765
Depreciation		101,636	105,057
Amortization		41	21
Employee welfare		59,040	47,290
Advertising		104,862	111,192
Commissions		127,767	109,756
Other expenses		126,317	67,427
	₩	1,755,240	1,663,098

(b) Details of selling, general and administrative expenses for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Salaries	₩	232,573	233,623
Retirement and termination benefits		24,078	23,708
Employee welfare		42,685	34,376
Travel		8,923	6,587
Communications		3,076	3,342
Utilities		8,591	8,091
Taxes and dues		18,178	17,282
Supplies		1,973	1,979
Rent		12,575	12,849
Depreciation		33,428	31,992
Amortization		41	21
Repairs and maintenance		4,367	3,937
Vehicles		3,987	4,090
Insurance		374	274
Commissions		94,521	79,743
Freight and custody		27,781	23,794
Conferences		3,103	2,769
Advertising		104,714	111,043
Training		3,796	3,712
Prizes and rewards		2,007	1,762
Normal research and development		15,931	11,757
Impairment loss (reversal of impairment loss) on trade receivables		9,976	(1,752)
	₩	656,678	614,979

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28. Other Income and Expenses

(a) Details of other income for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Foreign currency transaction gain	₩	8,632	19,816
Foreign currency translation gain		845	44,757
Reversal of impairment loss on other receivables		24,816	-
Gain on sale of property, plant and equipment		4,910	15,342
Gain on sale of intangible assets		595	-
Reversal of intangible asset impairment loss		595	-
Reversal of impairment loss on investments in subsidiaries		5,383	-
Gain on sale of investments in associates		19	6,095
Others		72,606	40,568
	₩	118,401	126,578

(b) Details of other expenses for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Foreign currency transaction loss	₩	45,956	27,763
Foreign currency translation loss		92,524	1,907
Impairment loss on other receivables		-	27,331
Loss on sale of property, plant and equipment		1,610	1,038
Loss on sale of intangible assets		3,135	16
Loss on disposal of investments in associates and joint ventures		8,945	-
Impairment loss on investments in subsidiaries		70,103	-
Donations		8,604	27,426
Others		11,009	6,367
	₩	241,886	91,848

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29. Net Finance Income

(a) Details of net finance income for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Finance income:			
Interest income	₩	40,657	37,048
Dividend income		90,647	18,146
Interest income on long-term deposits in MSA Escrow Fund		2,547	-
Gain on sale of available-for-sale financial assets		3,149	13,988
Gain on conversion of redeemable convertible preferred shares		-	311
		137,000	69,493
Finance costs:			
Interest expense		(942)	(1,138)
Impairment loss on available-for-sale financial assets		(18,523)	(4,077)
Investment loss on long-term deposits in MSA Escrow Fund		-	(3,721)
		(19,465)	(8,936)
Net finance income	₩	117,535	60,557

(b) Details of interest income for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Deposits	₩	37,032	28,447
Available-for-sale financial assets		7	30
Trade and other receivables		3,618	8,571
	₩	40,657	37,048

(c) Details of interest expense for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Trade and other payables	₩	942	1,138

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For the years ended December 31, 2017 and 2016

30. Income Tax

(a) The components of income tax expense for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Current income tax expense	₩	295,973	326,776
Adjustments recognized in the period for current tax of prior periods		15,488	(10,295)
Changes in temporary difference		(37,358)	1,149
		274,103	317,630
Less: tax expense (benefit) recognized outside profit or loss		(10,102)	(4,613)
	₩	264,001	313,017

(b) Current and deferred tax expense (benefit) that were recognized outside profit or loss for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Current tax:			
Gain on sales of treasury shares	₩	-	6,107
Deferred tax:			
Net changes in fair value of available-for-sale financial assets		9,188	4,533
Remeasurements of the net defined benefit liabilities		914	(6,027)
		10,102	(1,494)
Tax expense (benefit) recognized outside profit or loss	₩	10,102	4,613

Income tax related to gain on sales of treasury shares was recognized directly in equity and income tax related to net changes in fair value of available-for-sale financial assets and remeasurements of the net defined benefit liabilities were recognized in other comprehensive income.

(c) Reconciliation of income tax expense based on statutory tax rate to actual income tax expense for the years ended December 31, 2017 and 2016 are as follows:

<i>In millions of won</i>		2017	2016
Profit before income tax	₩	1,238,897	1,400,365
Statutory tax rate		24.20%	24.20%
Income taxes at normal tax rate		299,787	338,862
Adjustment:			
Non-taxable income		(30,094)	(6,515)
Non-deductible expenses		3,854	3,802
Changes in unrecognized deferred tax		(31,957)	(11,736)
Tax credits and deduction		(597)	(224)
Adjustments recognized in the period for current tax of prior periods		15,489	(10,295)
Deferred income tax expense due to changes in tax rates (income)		15,270	-
Other		(7,751)	(877)
Income tax expense	₩	264,001	313,017
Effective tax rate		21.30%	22.40%

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Notes to the Separate Financial Statements

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30. Income Tax, Continued

(d) Changes in deferred income tax assets (liabilities) for the years ended December 31, 2017 and 2016 are as follows:

(i) For the years ended December 31, 2017

<i>In millions of won</i>		January 1 2017	Profit (loss)	Other comprehensive income (loss)	December 31 2017
Accumulated depreciation	₩	7,525	233	-	7,758
Allowance		14,754	(1,727)	-	13,027
Available-for-sale financial assets		10,679	5,177	(9,188)	6,668
Accrued expenses		23,884	7,012	-	30,896
Defined benefit liability		6,633	(5,462)	(914)	257
Treasury Shares		(8,525)	(1,162)	-	(9,687)
Investments in subsidiaries		(113,341)	41,110	-	(72,231)
Advanced depreciation provision		(14,493)	(1,976)	-	(16,469)
Reserve		(2,420)	2,420	-	-
Other		1,976	1,835	-	3,811
	₩	(73,328)	47,460	(10,102)	(35,970)

(ii) For the years ended December 31, 2016

<i>In millions of won</i>		January 1 2016	Profit (loss)	Other comprehensive income (loss)	December 31 2016
Accumulated depreciation	₩	7,576	(51)	-	7,525
Allowance		8,711	6,043	-	14,754
Available-for-sale financial assets		14,226	986	(4,533)	10,679
Accrued expenses		26,326	(2,442)	-	23,884
Defined benefit liability		4,704	(4,098)	6,027	6,633
Treasury Shares		(8,756)	231	-	(8,525)
Investments in subsidiaries		(106,837)	(6,504)	-	(113,341)
Advanced depreciation provision		(14,493)	-	-	(14,493)
Reserve		(4,840)	2,420	-	(2,420)
Other		1,204	772	-	1,976
	₩	(72,179)	(2,643)	1,494	(73,328)

(e) As of December 31, 2017 and 2016, deferred tax asset of W261,194 million and W127,567 million for temporary differences arising from investments in subsidiaries, associates and joint ventures was not recognized, respectively, because it is not probable that they will reverse in the foreseeable future.

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31. Earnings per Share

Basic and diluted earnings per share for the years ended December 31, 2017 and 2016 were as follows:

		2017	2016
Profit for the year in millions of won	₩	974,896	1,087,347
Weighted-average number of ordinary shares outstanding		126,265,127	126,168,347
Basic and diluted earnings per share in won	₩	7,721	8,618

The weighted-average number of ordinary shares outstanding is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor.

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32. Transactions and Balances with Related Parties

(a) Details of parent and subsidiary relationships and related companies as of December 31, 2017 and 2016 were as follows:

Subsidiary	Location	Percentage of ownership					
		2017			2016		
		Parent	Subsidiary	Total	Parent	Subsidiary	Total
Investments in subsidiaries							
Korea Ginseng Corporation	Korea	100.00%	-	100.00%	100.00%	-	100.00%
Yungjin Pharm. Co., Ltd. ^{(*)1}	Korea	52.45%	-	52.45%	53.00%	-	53.00%
Tae-a Industry Co., Ltd.	Korea	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	99.99%	-	99.99%	99.99%	-	99.99%
Korea Tabacos do Brasil Ltda.	Brazil	99.99%	-	99.99%	99.99%	-	99.99%
KT&G Pars	Iran	99.99%	-	99.99%	99.99%	-	99.99%
KT&G Rus L.L.C.	Russia	100.00%	-	100.00%	100.00%	-	100.00%
KT&G USA Corporation	USA	100.00%	-	100.00%	100.00%	-	100.00%
Cosmococ Co., Ltd. ^{(*)2,3}	Korea	98.56%	-	98.56%	98.49%	-	98.49%
Renzoluc Pte., Ltd. ^{(*)4}	Singapore	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Life Sciences Corporation ^{(*)1,5}	Korea	-	-	-	34.03%	-	34.03%
KGC Yebon Corporation	Korea	100.00%	-	100.00%	100.00%	-	100.00%
K-Q HongKong I, Limited ^{(*)6}	HongKong	-	-	-	100.00%	-	100.00%
PT KT&G Indonesia	Indonesia	99.99%	-	99.99%	99.99%	-	99.99%
K&I HK Co., Ltd. ^{(*)3}	HongKong	-	100.00%	100.00%	100.00%	-	100.00%
K&I China Co., Ltd. ^{(*)3}	China	-	100.00%	100.00%	100.00%	-	100.00%
SangSang Stay, Inc.	Korea	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Global Rus L.L.C. ^{(*)7}	Russia	100.00%	-	100.00%	100.00%	-	100.00%
KGC Life & Gin Co., Ltd. ^{(*)8}	Korea	-	100.00%	100.00%	-	100.00%	100.00%
Jilin Hanzheng Ginseng Co., Ltd.	China	-	100.00%	100.00%	-	100.00%	100.00%
Cheong Kwan Jang Taiwan Corporation	Taiwan	-	100.00%	100.00%	-	100.00%	100.00%
Korean Red Ginseng Corp., Inc.	USA	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng (China) Corp.	China	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng Corporation Japan	Japan	-	100.00%	100.00%	-	100.00%	100.00%
PT CKJ INDONESIA	Indonesia	-	99.88%	99.88%	-	99.88%	99.88%
PT Trisakti Purwosari Makmur ^{(*)9}	Indonesia	-	99.99%	99.99%	-	60.17%	60.17%
PT Mandiri Maha Mulia ^{(*)9}	Indonesia	-	99.98%	99.98%	-	66.47%	66.47%
PT Sentosa Ababi Purwosari ^{(*)9}	Indonesia	-	100.00%	100.00%	-	99.80%	99.80%
PT Purindo Ilufa ^{(*)9}	Indonesia	-	100.00%	100.00%	-	100.00%	100.00%
PT Nusantara Indah Makmur ^{(*)9}	Indonesia	-	100.00%	100.00%	-	-	-
Investments in associates and joint ventures							
Lite Pharm Tech, Inc.	Korea	20.24%	-	20.24%	20.24%	-	20.24%
KVG REIT 1 Co., Ltd. ^{(*)10}	Korea	-	-	-	29.67%	-	29.67%
JR REIT V Co., Ltd.	Korea	34.63%	-	34.63%	34.63%	-	34.63%
JR REIT VIII Co., Ltd.	Korea	21.74%	-	21.74%	21.74%	-	21.74%
LSK Global Pharma Services Co., Ltd.	Korea	23.15%	-	23.15%	23.15%	-	23.15%
JR REIT X Co., Ltd.	Korea	28.79%	-	28.79%	28.79%	-	28.79%
JR REIT XIII Co., Ltd.	Korea	27.03%	-	27.03%	27.03%	-	27.03%
KB Gimpo Logistics CR REIT Co., Ltd.	Korea	12.00%	-	12.00%	12.00%	-	12.00%
KORAMCO Private REIT 50 Fund	Korea	84.21%	-	84.21%	84.21%	-	84.21%
Yong-in Ceter Co., Ltd. ^{(*)11}	Korea	22.22%	-	22.22%	-	-	-

^(*) KT&G Life Sciences Corporation was merged into Yungjin Pharm. Co., Ltd. as of January 13, 2017.

^(*) The ownership interest in Cosmococ Co., Ltd. has increased to 98.49% from 97.73% as a result of the conversion of redeemable convertible preferred shares in 2016.

^(*) For the years ended December 31, 2017, the Company made a capital contribution in-kind to Cosmococ Co., Ltd. by transferring its interest in K&I HK Co., Ltd. and K&I China Co., Ltd., increasing its ownership from 98.49% to 98.56%.

^(*) The percentage of ownership, shown above, excludes preferred shares. As of December 31, 2017, the Company's percentage of ownership would be 88.6%, if preferred shares are included.

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32. Transactions and Balances with Related Parties, Continued

(a) Details of parent and subsidiary relationships and related companies as of December 31, 2017 and 2016 were as follows, Continued:

- (*5) The ownership interest in KT&G Life Sciences Corporation has decreased to 34.03% from 73.94% as a result of the conversion of redeemable convertible preferred shares in 2016.
- (*6) For the years ended December 31, 2017, K-Q HongKong I, Limited was liquidated.
- (*7) The Company established KT&G Global Rus L.L.C in 2016.
- (*8) The Company made a capital contribution in-kind of its entire interest in KGC Life & Gin Co., Ltd. to Korea Ginseng Corporation in 2016.
- (*9) For the year ended December 31, 2017, PT Trisakti Purwosari Makmur, a subsidiary, acquired PT Nusantara Indah Makmur.
- (*10) For the year ended December 31, 2017, KVG REIT 1 Co, Ltd. was liquidated
- (*11) For the year ended December 31, 2017, the Company acquired a 22.22% shares in Yong In Jung Sim Co., Ltd.
- (*12) Renzoluc Pte., Ltd acquired additional shares of PT Sentosa Ababi Purwosari, PT Trisakti Purwosari Makmur and PT Mandiri Maha Mulia for the years ended December 31, 2017, its ownership interest increased to 100.00%, 99.99% and 99.98% from 99.8%, 60.17% and 66.47%, respectively.

(b) Significant transactions which occurred in the normal course of business with related companies for the years ended December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017		2016	
		Sales and other income	Purchase and other expenses	Sales and other income	Purchase and other expenses
Korea Ginseng Corporation	₩	7,841	2,574	7,679	2,575
Yungjin Pharm. Ind. Co., Ltd.		208	37	282	13
Tae-a Industry Co., Ltd.		13	13,984	14	13,857
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		8,381	-	2,700	-
KT&G Pars		2,101	-	324	-
KT&G Rus L.L.C.		22,828	-	21,887	-
KT&G USA Corporation		107,847	-	122,394	-
Cosmococ Co., Ltd.		122	128	147	452
Renzoluc Pte., Ltd.		763	-	4,050	-
KT&G Life Sciences Corporation		-	-	18	-
KGC Yebon Corporation		26	48	106	260
PT KT&G Indonesia		1,138	-	1,603	-
K&I China Co., Ltd.		-	23	1,200	76
SangSang Stay, Inc.		6,545	-	3,843	33
KGC Life & Gin Co., Ltd.		386	187	632	323
PT Trisakti Purwosari Makmur		13	-	187	-
PT Mandiri Maha mulia		13,361	-	7,934	-
PT Sentosa Ababi Purwosari		170	-	-	-
PT Purindo Ilufa		128	-	-	-
	₩	171,871	16,981	175,000	17,589

In addition, the Company disposed of property, plant and equipment with a carrying amount of ₩2,454 million and ₩114 million to KT&G Rus L.L.C and PT Mandiri Maha mulia, respectively, during the year ended December 31, 2017.

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32. Transactions and Balances with Related Parties, Continued

(b) Significant transactions which occurred in the normal course of business with related companies for the years ended December 31, 2017 and 2016 are summarized as follows, Continued:

In addition, the Company disposed of property, plant and equipment with a carrying amount of ₩4,920 million, ₩3,392million and ₩1,123million to SangSang Stay, Inc., PT Mandiri Maha mulia and KT&G Rus L.L.C, respectively, during the year ended December 31, 2016.

(c) Account balances with related companies as of December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>	2017		2016	
	Receivables	Payables	Receivables	Payables
Investments in subsidiaries				
Korea Ginseng Corporation	343	2,075	37	2,071
Yungjin Pharm. Co., Ltd.	66	30	13	30
Tae-a Industry Co., Ltd.	4	-	-	-
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	37,029	-	38,159	-
Korea Tabacos do Brasil Ltda.	103	-	101	-
KT&G Pars ^(*)	43,791	-	43,385	-
KT&G Rus L.L.C. ^(*)	53,810	-	58,652	-
KT&G USA Corporation	38,696	-	19,015	-
Cosmococ Co., Ltd.	29	16	-	27
Renzoluc Pte., Ltd.	-	-	50,923	-
KT&G Life Sciences Corporation	-	-	-	1
KGC Yebon Corporation	3	-	-	-
PT KT&G Indonesia	27,380	-	31,185	-
K&I China Co., Ltd.	-	-	1,074	-
SangSang Stay, Inc.	3	-	552	-
KGC Life & Gin Co., Ltd.	14	120	-	115
PT Trisakti Purwosari Makmur	313	-	353	-
PT Mandiri Maha Mulia	13,279	-	11,050	-
PT Sentosa Ababi Purwosari	162	-	-	-
Investments in associates and joint ventures				
LSK Global Pharma Services Co., Ltd.	1,500	-	-	-
	216,525	2,241	254,499	2,244

^(*) Above receivables are the gross amounts before ₩38,176 million and ₩49,965 million of allowance for doubtful accounts as of December 31, 2017 and 2016, respectively.

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32. Transactions and Balances with Related Parties, Continued

(d) Details of financial transactions with related parties for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>	Capital Increase	Increase	2017	2016
			Loans Collection	Capital Increase
Investments in subsidiaries				
Korea Ginseng Corporation	-	-	-	44,100
Yungjin Pharm. Co., Ltd.	6,944	-	-	-
Cosmococ Co., Ltd.	5,544	-	-	27,417
Renzoluc Pte., Ltd.	144,691	-	47,489	-
KT&G Life Sciences Corporation	-	-	-	1,564
KT&G Global Rus L.L.C.	-	-	-	1,497
Investments in associates and joint ventures				
LSK Global Pharma Services Co., Ltd.	-	2,054	554	-
Yong In Jung Sim Co., Ltd.	1,000	-	-	-
	158,179	2,054	48,043	74,578

KT&G Life Sciences Corporation was merged into Yungjin Pharm. Co., Ltd. as of January 13, 2017.

For the year ended December 31, 2017, the Company invested ₩97,202 million in cash to acquire additional 25,641,958 shares of Renzoluc Pte and acquired additional 13,151,932 shares of Renzoluc Pte due to conversion of loans amounting to ₩47,489.

For the years ended December 31, 2017, the Company acquired ₩5,544 million of additional interest in Cosmococ Co., Ltd. through a capital contribution in-kind of its interest in K&I HK Co., Ltd. and K&I China Co., Ltd.

During the years ended December 31, 2016, the Company acquired ₩44,100 million of additional shares of Korea Ginseng Corporation through a capital contribution in-kind of its entire investment in KGC Life & Gin Co., Ltd.

Before the years ended December 31, 2016, the Company invested ₩26,000 million to KOFC QCP IBKC Frontier Champ 2010-2 Private Equity Fund in cash to acquire 97,079 shares of Cosmococ Co., Ltd. During the years ended December 31, 2016, the Company acquired ₩27,417 million of additional shares of Cosmococ Co., Ltd. as a result of the conversion of its redeemable convertible preferred shares.

(e) Details of key management personnel compensation for the years ended December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>		2017	2016
Short-term employee benefits	₩	18,548	16,539
Retirement benefits		1,777	1,704
	₩	20,325	18,243

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33. Risk Management and Fair Value of Financial Instruments

(a) Overview

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

- Market risk
- Credit risk
- Liquidity risk

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

(b) Risk Management Framework

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

(c) Management of Financial Risks

(i) Market risk

Market risk is the risk that changes in market prices – such as foreign exchange rates, interest rates and equity prices – will affect the Company's income or the value of its financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimizing the return.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

33. Risk Management and Fair Value of Financial Instruments, Continued

(c) Management of Financial Risks, Continued

(i) Market risk, Continued

Currency risk

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

The carrying amounts of monetary assets and liabilities denominated in a currency other than the functional currency as of December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>	2017		2016	
	Assets	Liabilities	Assets	Liabilities
USD	1,039,421	30,912	1,085,906	52,680
IDR	1,581	-	51,593	-
EUR	33,424	3,580	29,630	3,023
Others	27,991	-	11,213	-
	1,102,417	34,492	1,178,342	55,703

As of December 31, 2017 and 2016, the effects of a 10% weakening or strengthening of functional currency against foreign currencies on profit before tax were as follows:

<i>In millions of won</i>	2017		2016	
	10% weakening	10% strengthening	10% weakening	10% strengthening
Increase (decrease) in profit before tax	106,793	(106,793)	112,264	(112,264)

Equity price risk

The Company has exposure to equity price risk, which arises from listed available-for-sale equity instruments. The Company's management has monitored the proportion of equity instruments in its investment portfolio based on market indices. Material investments within the portfolio are managed on an individual basis, and all buy and sell decisions are approved by the Company's management.

As of December 31, 2017 and 2016, the effects of a 5% fluctuation in the price index of stocks on comprehensive income before tax were as follows:

<i>In millions of won</i>	2017		2016	
	5% increase	5% decrease	5% increase	5% decrease
Comprehensive income before tax	6,706	(6,706)	5,162	(5,162)

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

33. Risk Management and Fair Value of Financial Instruments, Continued

(c) Management of Financial Risks, Continued

(i) Market risk, Continued

Interest rate risk

The Company has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company's management has monitored the level of interest rates regularly and has maintained the balance of borrowings at variable rates and fixed rates. As of December 31, 2017, there is no significant effect on cash flows or the fair value of financial liabilities from the interest rate fluctuation, considering the amounts of interest bearing liabilities.

(ii) Credit risk

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

The carrying amount of financial assets is maximum exposure to credit risk. The maximum exposure to credit risk as of December 31, 2017 and 2016 is as follows:

<i>In millions of won</i>	2017	2016
Available-for-sale debt instruments	-	1,500
Long-term deposits in MSA Escrow Fund	510,223	503,592
Trade and other receivables	1,031,970	1,208,615
Other financial assets	1,536,340	1,620,000
Cash and cash equivalents (excluding cash on hand)	1,104,120	687,640
Financial guarantee contracts	-	153,145
	4,182,653	4,174,492

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

33. Risk Management and Fair Value of Financial Instruments, Continued

(c) Management of Financial Risks, Continued

(iii) Liquidity risk

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

The contractual maturity analysis with a residual contractual maturity of financial liabilities as of December 31, 2017 and 2016 is as follows:

			Residual contractual maturity			
<i>In millions of won</i>	Carrying amount	Contractual cash flow	Within 3 months	Between 3 months and 1 year	Between 1 and 5 years	More than 5 years
As of December 31, 2017:						
Trade and other payables	₩ 243,751	244,566	210,997	23,405	9,879	285
Short-term borrowings	1,959	1,959	1,959	-	-	-
	₩ 245,710	246,525	212,956	23,405	9,879	285
As of December 31, 2016:						
Trade and other payables	₩ 252,969	253,467	224,703	21,584	7,180	-
Short-term borrowings	3,851	3,851	3,851	-	-	-
Financial guarantee contracts	-	153,145	-	153,145	-	-
	₩ 256,820	410,463	228,554	174,729	7,180	-

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

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

33. Risk Management and Fair Value of Financial Instruments, Continued

(d) Fair Value of Financial Instruments

The carrying amounts of each category of financial assets and liabilities as of December 31, 2017 and 2016 are summarized as follows:

<i>In millions of won</i>	2017	2016
Financial assets:		
Available-for-sale financial assets	454,051	365,805
Loans and receivables		
–Trade and other receivables	1,031,970	1,208,615
–Long-term deposits in MSA Escrow Fund	510,223	503,592
–Other financial assets (excluding derivatives)	1,536,340	1,620,000
–Cash and cash equivalents	1,104,825	688,735
	<u>4,183,358</u>	<u>4,020,942</u>
	4,637,409	4,386,747
Financial liabilities:		
Financial liabilities measured at amortized cost		
–Trade and other payables	243,751	252,969
–Short-term borrowings	1,959	3,851
	<u>245,710</u>	<u>256,820</u>

The fair value measurements classified by fair value hierarchy as of December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		Carrying amount	Level I	Level II	Fair value Level III
As of December 31, 2017:					
Available-for-sale financial assets	₩	404,329	220,160	-	184,169
As of December 31, 2016:					
Available-for-sale financial assets	₩	333,250	200,294	-	132,956

There is no transfer between fair value hierarchy levels of recurring fair value measurements for the year ended December 31, 2017 and 2016.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

33. Risk Management and Fair Value of Financial Instruments, Continued

(d) Fair Value of Financial Instruments, Continued

The fair value measurements for available-for-sale equity instruments in real estate trust fund has been measured using the adjusted net asset method, DCF and option pricing model and categorized as a level 3 fair value based on the inputs to the valuation techniques used. Changes in fair value classified as level 3 for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Beginning balance	₩	132,956	127,084
Acquisition		70,946	16,000
Exercise of conversion options		-	(11,976)
Disposal		(22,798)	-
Changes in fair value		3,065	1,848
Ending balance	₩	184,169	132,956

(e) Details of finance income (costs) by categories for the years ended December 31, 2017 were as follows:

<i>In millions of won</i>		Available -for-sale Financial assets	Loan and receivables	Financial liabilities measured at amortized cost	Total
Profit or loss:					
Interest income	₩	7	40,650	-	40,657
Dividend income		19,647	-	-	19,647
Investment income on long-term deposits in MSA Escrow Fund		-	2,547	-	2,547
Gain on sale		3,149	-	-	3,149
Interest expense		-	-	(942)	(942)
Impairment loss		(18,523)	14,840	-	(3,683)
	₩	4,280	58,037	(942)	61,375
Other comprehensive income before tax					
Net change in fair value	₩	22,931	-	-	22,931
Reclassification adjustments on sale		(3,149)	-	-	(3,149)
Reclassification adjustments on impairment		18,523	-	-	18,523
	₩	38,305	-	-	38,305

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

33. Risk Management and Fair Value of Financial Instruments, Continued

(e) Finance Income (Costs), Continued

(ii) Details of finance income (costs) by categories for the years ended December 31, 2016 were as follows:

<i>In millions of won</i>	Available -for-sale financial assets	Loans and receivables	Financial liabilities measured at amortized cost	Total
Profit or loss:				
Interest income	30	37,018	-	37,048
Dividend income	15,129	-	-	15,129
Gain on conversion of redeemable convertible preferred shares	-	311	-	311
Gain on sale	13,988	-	-	13,988
Interest expense	-	-	(1,138)	(1,138)
Investment loss on long-term deposits in MSA Escrow Fund	-	(3,721)	-	(3,721)
Impairment loss	(4,077)	(25,579)	-	(29,656)
	25,070	8,029	(1,138)	31,961
Other comprehensive income (loss) before tax				
Net change in fair value	28,643	-	-	28,643
Reclassification adjustments on sale	(13,988)	-	-	(13,988)
Reclassification adjustments on impairment	4,077	-	-	4,077
	18,732	-	-	18,732

34. Capital Management

The Company's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The board of directors seeks to maintain a balance between the higher returns that might be possible with higher levels of borrowings and the advantages and security afforded by a sound capital position.

The Company monitors capital using equity and net debt by deducting cash and cash equivalents and current financial instruments from borrowings. The Company applied the same capital management strategy that was applied in the previous year.

As of December 31, 2017 and 2016, the Company's equity and net debt are as follows:

<i>In millions of won</i>	2017	2016
Debt (borrowings)	₩ 1,959	3,851
Less:		
Cash and cash equivalents	(1,104,825)	(688,735)
Current other financial assets	(1,530,000)	(1,620,000)
Net debt (asset)	(2,632,866)	(2,304,884)
Equity	₩ 7,143,557	6,578,897

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

35. Contingent Liabilities and Commitments

(a) Each year the Company 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 Company 25 years from the date of each annual funding. The Company recorded as long-term deposits the amounts paid into the MSA Escrow Funds of State governments in the United States against potential litigation and damages related to the export of tobacco into the United States.

(b) As of December 31, 2017, a lawsuit by National Health Insurance Service claiming damages of ₩53,742 million has been filed against the Company. Additionally, as of December 31, 2017, the Company is involved in ten lawsuits as a plaintiff for alleged damages totalling ₩26,053 million and two lawsuits as a defendant for alleged damages totalling ₩213 million. The amount of the liability the Company may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of December 31, 2017.

(c) As of December 31, 2017, the Company has entered into letter of credit agreements with KEB Hana Bank and other bank with limits in the aggregate of USD 57,000 thousand.

(d) As of December 31, 2017, the Company's trade receivables from the export of cigarettes are insured against non-payment up to USD 31,833 thousand by short-term export insurances with the Korea Trade Insurance Corporation.

(e) The Company has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries up to USD 40,000 thousand and USD 20,000 thousand by KEB Hana Bank and Westchester Fire Insurance Company. Details of guarantees exercised as of December 31, 2017, are summarized as follows:

<i>In thousands of USD, THB and millions of IDR</i>		<i>Exercised amount</i>
Customs bond and L/C opening of KT&G USA Corporation	USD	31,417
Performance guarantee for export of tobacco sheet to Thailand Tobacco Monopoly	THB	6,043
Payment guarantee for purchase of certificate stamp of PT Mandiri Maha Mulia, etc.	IDR	79,424

(f) On March 17, 2011, the Company 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.

(g) As of December 31, 2017, the Company has been provided with guarantees of USD 2,630 thousand from TRAVELERS CASUALTY AND SURETY COMPANY OF AMERICA for the execution of escrow deposits.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

35. Contingent Liabilities and Commitments, Continued

(h) With relation to the acquisition of KT&G Life Sciences Corporation, the Company entered into a contract with a former owner of the acquiree, Gwak, Tae-Hwan ("Individual Shareholder"). Details of the contract are as follows:

Description	Details
Restriction of disposal	Individual Shareholder shall not be permitted to dispose of its shares, in whole or in part, within one year after KT&G Life Sciences Corporation is listed.
Right of first refusal held by the Company	Individual Shareholder shall not be permitted to make any transfer of its shares, in whole or in part, unless Individual Shareholder has offered them first to the Company.
Tag-along right held by Individual Shareholder	In the event that the Company proposes to enter into a transaction or a series of related transactions with a third party purchaser to dispose of its shares, then Individual Shareholder shall elect to participate in such disposition upon the terms and conditions no less favorable than those applicable to the Company.

(i) As of December 31, 2017, the Company is insured by performance bond insurance up to ~~₩~~4,164 million with the Seoul Guarantee Insurance.

(j) As of December 31, 2017, the Company recognizes other financial assets of ~~₩~~6,340 million deposited in Nonghyup bank and restricted in use in order to provide a performance guarantee for the commercial district development project in Sejong-si.

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

36. Cash Flows

(a) Details of cash generated from operations for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>		2017	2016
Profit for the year	₩	974,896	1,087,347
Adjustments for:			
Income tax expense		264,001	313,017
Finance costs		19,465	8,936
Finance income		(137,000)	(69,493)
Depreciation		101,636	105,057
Amortization		41	21
Retirement and termination benefits		34,104	33,765
Employee benefits		12,090	-
Foreign currency translations loss		92,524	1,907
Loss on sale of property, plant and equipment		1,610	1,038
Loss on sale of intangible assets		3,135	16
Reversal of intangible asset impairment loss		(595)	-
Loss on sale of investment in subsidiaries		8,945	-
Impairment loss of investment in subsidiaries		70,103	-
Reversal of impairment loss on investments in subsidiaries		(5,383)	-
Other expenses		17,502	6,257
Foreign currency translations gain		(845)	(44,757)
Reversal of impairment loss on trade and other receivables		(14,840)	25,579
Loss on (reversal of) write-down of inventory		64	728
Gain on sale of property, plant and equipment		(4,910)	(15,342)
Gain on sale of intangible assets		(595)	-
Loss on sale of investment in associates and joint ventures		(19)	(6,095)
		1,435,929	1,447,981
Changes in working capital:			
Trade and other receivables		112,888	(67,888)
Advance payments		2,013	4,217
Prepaid expenses		3,846	637
Prepaid tobacco excise and other taxes		183,591	8,358
Inventories		36,243	(32,652)
Trade and other payables		(52,085)	29,858
Advance receipts		(166)	(25,531)
Tobacco excise and other taxes payable		(232,261)	381,906
Payment of retirement and termination benefits		(48,332)	(52,683)
Cash generated from operations	₩	1,441,666	1,694,203

KT&G CORPORATION

Notes to the Separate Financial Statements

For the years ended December 31, 2017 and 2016

36. Cash Flows, Continued

(b) Details of material transactions without cash inflow and outflow for the years ended December 31, 2017 and 2016 were as follows:

<i>In millions of won</i>	2017	2016
In-kind donation of treasury shares ₩	-	34,140
Acquisition of investment in subsidiaries upon exercise of conversion options	-	27,414
Increase in accrued expenses		
related to payment of retirement and termination benefits	(2,305)	1,040
Increase (decrease) in other payables		
related to acquisition of property, plant and equipment	(1,301)	2,092
Increase in other receivables related to disposal of		
property, plant and equipment and non-current assets held for sale	2,686	4,319
Acquisition of investments in subsidiaries due to the transfer of subsidiary loans	47,489	-
Substitution of available-for-sale financial assets	2,054	-
In-kind capital contribution of investment in subsidiaries	-	44,100

(c) Details of changes from financing activities for the years ended December 31, 2017, were as follows:

<i>In millions of won</i>	January 1 2017	Cash flows from financing activities	Others	December 31 2017
Payable dividends ₩	-	(454,554)	454,554	-
Short-term borrowings	3,851	-	(1,892)	1,959
Deposits received	28,266	4,805	(317)	32,754
₩	32,117	(449,749)	452,345	34,713

(d) Details of changes from financing activities for the years ended December 31, 2016, were as follows:

<i>In millions of won</i>	January 1 2016	Cash flows from financing activities	Others	December 31 2016
Payable dividends ₩	-	(428,284)	428,284	-
Short-term borrowings	5,031	-	(1,180)	3,851
Deposits received	26,434	495	220	28,266
₩	32,582	(427,789)	427,324	32,117

(e) The company presented cash flows arising from short-term financial instruments on a net basis.

Independent Accountants' Review Report on Internal Accounting Control System

English translation of a Report Originally Issued in Korean

To the President of
KT&G Corporation:

We have reviewed the accompanying Report on the Operations of Internal Accounting Control System ("IACS") of KT&G Corporation (the "Company") as of December 31, 2017. The Company's management is responsible for designing and maintaining effective IACS and for its assessment of the effectiveness of IACS. Our responsibility is to review management's assessment and issue a report based on our review. In the accompanying report of management's assessment of IACS, the Company's management stated: "Based on the assessment on the operations of the IACS, the Company's IACS has been effectively designed and is operating as of December 31, 2017, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee."

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

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

Based on our review, nothing has come to our attention that Report on the Operations of Internal Accounting Control System as of December 31, 2016 is not prepared in all material respects, in accordance with IACS Framework issued by the Internal Accounting Control System Operation Committee.

This report applies to the Company's IACS in existence as of December 31, 2017. We did not review the Company's IACS subsequent to December 31, 2017. This report has been prepared for Korean regulatory purposes, pursuant to the External Audit Law, and may not be appropriate for other purposes or for other users.

Seoul, Korea
February 28, 2018

Notice to Readers

This report is annexed in relation to the audit of the separate financial statements as of December 31, 2017 and the review of internal accounting control system pursuant to Article 2-3 of the Act on External Audit for Stock Companies of the Republic of Korea.

Report on the Operations of Internal Accounting Control System

English Translation of a Report Originally Issued in Korean

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

I, as the Internal Accounting Control Officer ("IACO") of KT&G Corporation (the "Company"), assessed the status of the design and operations of the Company's internal accounting control system ("IACS") for the year ended December 31, 2017.

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

Based on the assessment of the operations of the IACS, the Company's IACS has been effectively designed and is operating as of December 31, 2017, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee.

January 31, 2018

Kang, Kyeong Bo Internal Accounting Control Officer



Baek, Bok In President and Chief Executive Office

