KT&G CORPORATION

Non-Consolidated Financial Statements

December 31, 2008 and 2007

(With Independent Auditors' Report Thereon)

Contents

<u>Independent Auditors' Report</u>

<u>Based on a report originally issued in Korean</u>

The Board of Directors and Stockholders
KT&G Corporation:

We have audited the accompanying non-consolidated balance sheets of KT&G Corporation (the "Company") as of December 31, 2008 and 2007, and the related non-consolidated statements of income, appropriation of retained earnings, changes in equity and cash flows for the years then ended. These non-consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these non-consolidated financial statements based on our audits.

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

In our opinion, the non-consolidated financial statements referred to above present fairly, in all material respects, the financial position of KT&G Corporation as of December 31, 2008 and 2007, and the results of its operations and the appropriation of its retained earnings, the changes in its equity and its cash flows for the years then ended in conformity with accounting principles generally accepted in the Republic of Korea.

The accompanying non-consolidated financial statements as of and for the year ended December 31, 2008 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation and, in our opinion, the non-consolidated financial statements expressed in Korean Won have been translated into dollars on the basis set forth in note 3 to the non-consolidated financial statements.

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

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

As discussed in note 20 to the non-consolidated financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩759 million for the effects of smoking. The final outcome of these lawsuits cannot be predicted. Accordingly, no provisions have been made in the accompanying non-consolidated financial statements

As discussed in note 31 to the non-consolidated financial statements, the Company changed accounting policy on equity method accounted investments in conformity with Statement of Korea Accounting Standard "SKAS" No. 15 *Investment In Associates*, revised February 22, 2008 which required, when accounting on equity method accounted investments, that net assets of non-consolidated financial statements agree with those of consolidated financial statements.

These changes resulted in a decrease in loss on valuation of equity method investments of ₩13 million, equity method investment securities of ₩12 million and unrealized gain on valuation of equity method investments of ₩2,596 million and an increase in capital surplus of ₩2,532 million and unappropriated retained earnings of ₩52 million, respectively. The Company restated prior period's financial statements in conformity with these changes in accounting policy.

As discussed in note 35 to the non-consolidated financial statements, all listed companies are required to comply with International Financial Reporting Standards ("K-IFRS") from 2011 and the Company has decided to early-adopt K-IFRS in 2009.

Seoul, Korea
January 23, 2009

This report is effective as of January 23, 2009, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying non-consolidated financial statements and notes thereto. Accordingly, the readers of the audit report should understand that there is a possibility that the above audit report may have to be revised to reflect the impact of such subsequent events or circumstances, if any.

KT&G CORPORATION

Non-Consolidated Balance Sheets

As of December 31, 2008 and 2007

In millions of Won, and thousands of US dollars	Note		2008 Korean Won		2008 U.S. dollars (note 3)		2007 Korean Won
Assets							
Cash and cash equivalents	16	₩	88,352	$	70,260	₩	115,126
Short-term financial instruments			1,000		795		1,000
Trade accounts receivable, net of allowance for doubtful accounts of ₩20,266 in 2008 and ₩8,723 in 2007	8,16		407,171		323,795		294,895
Inventories	4,12		1,075,512		855,278		979,513
Current deferred tax assets	22		9,249		7,355		16,026
Other current assets	5		129,690		103,133		60,585
Total current assets			1,710,974		1,360,616		1,467,145
Available-for-sale securities	6		309,178		245,867		257,089
Equity method investment securities	7,31		705,286		560,864		626,668
Property, plant and equipment, net	9,10,12		1,398,775		1,112,346		1,408,958
Intangible assets	11		1,188		946		1,719
Long-term loans to employees	8		79,948		63,577		95,939
Guarantee deposits paid			33,219		26,415		30,520
Guarantee deposits for membership			22,140		17,606		21,197
Long-term deposits in escrow fund	16,20		110,261		87,683		66,633
Other non-current assets	13		11,604		9,228		1,933
Total non-current assets			2,671,599		2,124,532		2,510,656
Total assets		₩	4,382,573	$	3,485,148	₩	3,977,801

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Balance Sheets, Continued

As of December 31, 2008 and 2007

In millions of Won and thousands of US dollars except share data	Note	2008 Korean Won	2008 U.S. dollars (note 3)	2007 Korean Won
Liabilities				
Trade accounts payable	8,16	₩ 27,543	$ 21,903	₩ 9,590
Value added tax payable		125,184	99,550	128,866
Accrued expenses		13,280	10,561	12,320
Other payables		139,775	111,153	95,432
Income taxes payable		153,486	122,056	183,482
Tobacco excise and other taxes payable		168,423	133,935	181,734
Other current liabilities	14	15,581	12,390	11,299
Total current liabilities		643,272	511,548	622,723
Retirement and severance benefits	15,29	38,517	30,630	64,360
Guarantee deposits received	8	24,954	19,844	26,861
Deferred income tax liabilities	22	136,001	108,152	121,854
Total non-current liabilities		199,472	158,626	213,075
Total liabilities		842,744	670,174	835,798
Equity				
Common stock of ₩5,000 par value Authorized – 800,000,000 shares Issued – 138,792,497 shares in 2008 and 143,442,497 shares in 2007 Outstanding – 128,698,800 shares in 2008 and 130,839,907 shares in 2007	1	954,959	759,411	954,959
Capital surplus	31	471,144	374,667	466,769
Capital adjustments	17	(224,650)	(178,648)	(414,947)
Accumulated other comprehensive income	6,7,18, 30,31	30,659	24,381	1,593
Retained earnings	19,31	2,307,717	1,835,163	2,133,629
Total equity		3,539,829	2,814,974	3,142,003
Total equity and liabilities		₩ 4,382,573	$ 3,485,148	₩ 3,977,801

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Income

For the years ended December 31, 2008 and 2007

In millions of Won and thousands of US dollars, except earnings per share	Note		2008 Korean Won		2008 U.S. dollars (note 3)		2007 Korean Won
Sales							
Tobacco	8	₩	2,514,164	$	1,999,335	₩	2,342,411
Lotting-out	21		71,975		57,237		19,815
Other	8		58,517		46,534		50,463
			2,644,656		2,103,106		2,412,689
Cost of sales	8,21,26,27		1,023,034		813,546		992,449
Gross profit			1,621,622		1,289,560		1,420,240
Selling, general and administrative expenses	26,27,28		646,298		513,954		605,839
Operating income			975,324		775,606		814,401
Other income (expense):							
Interest income			21,152		16,821		38,193
Interest expense			(647)		(515)		(101)
Gain (loss) on foreign currency transactions, net			49,369		39,260		(445)
Gain on foreign currency translation, net			25,332		20,146		2,361
Gain (loss) on sale of available-for-sale securities			84		67		(724)
Gain on sale of property, plant and equipment, net			11,191		8,899		5,489
Provision for Tobacco Production Stabilization Fund			-		-		(35,516)
Gain on valuation of equity method investments	7,31		145,046		115,345		128,302
Loss on valuation of equity method investments	7,31		(10,340)		(8,223)		(24,987)
Loss on valuation of derivative instruments	32		(2,699)		(2,146)		(25)
Gain (loss) on transaction of derivative instruments, net			(6,295)		(5,006)		25
Donations	27		(28,020)		(22,282)		(24,995)
Other, net			1,806		1,435		5,125
Other income			205,979		163,801		92,702
Income before income taxes			1,181,303		939,407		907,103
Income taxes	22		287,013		228,242		245,897
Net income		₩	894,290	$	711,165	₩	661,206
Earnings per share							
Basic earnings per share	23	₩	6,872	$	5	₩	4,992

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Appropriation of Retained Earnings

For the years ended December 31, 2008 and 2007

Date of Appropriation for 2008: March 13, 2009
Date of Appropriation for 2007: March 14, 2008

In millions of Won and thousands of US dollars		2008 Korean Won		2008 U.S. dollars (note 3)		2007 Korean Won
Unappropriated retained earnings						
Balance at beginning of year	₩	1,865	$	1,483	₩	5,492
Cumulative effect of change in accounting policy		-		-		26
Retirement of treasury stock		(379,753)		(301,990)		(269,410)
Net income		894,290		711,165		661,206
Balance at end of year before appropriation		516,402		410,658		397,314
Transfer from voluntary reserves						
Reserve for research and manpower development		15,000		11,928		15,000
Unappropriated retained earnings available for appropriation		531,402		422,586		412,314
Appropriation of retained earnings						
Unconditional reserve		169,000		134,394		70,000
Dividends – 56% on par value at 2,800 Won per share in 2008 and 52% on per value at 2,600 Won per share in 2007 (note 24)		360,357		286,566		340,449
		529,357		420,960		410,449
Unappropriated retained earnings to be carried over to subsequent year	₩	2,045	$	1,626	₩	1,865

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Changes in Equity

For the years ended December 31, 2008 and 2007

In millions of Won		Korean Won					
		Capital stock	Capital surplus	Capital adjust-ments	Accumu-lated other compre-hensive income	Retained earnings	Total equity
Balance at January 1, 2007	₩	954,959	335,414	(321,904)	15,784	2,061,520	3,045,773
Cumulative effect of change in accounting policy		-	839	-	(903)	26	(38)
Balance at January 1, 2007, restated		954,959	336,253	(321,904)	14,881	2,061,546	3,045,735
Dividends		-	-	-	-	(319,712)	(319,712)
Net income		-	-	-	-	661,206	661,206
Decrease in unrealized gain on valuation of available-for-sale securities		-	-	-	(13,829)	-	(13,829)
Increase in unrealized gain on valuation of equity method investments		-	1,693	-	285	-	1,978
Decrease in unrealized loss on valuation of equity method investments		-	-	-	256	-	256
Reacquisition of treasury stock		-	-	(455,035)	-	-	(455,035)
Retirement of treasury stock		-	-	269,411	-	(269,411)	-
Compensation by treasury stock		-	128,823	92,581	-	-	221,404
Balance at December 31, 2007	₩	954,959	466,769	(414,947)	1,593	2,133,629	3,142,003

In millions of Won, and thousands of US dollars		Korean Won							U.S. dollars (note 3)
		Capital stock	Capital surplus	Capital adjust-ments	Accumu-lated other compre-hensive income	Retained earnings	Total equity		Total equity
Balance at January 1, 2008	₩	954,959	464,237	(414,947)	4,189	2,133,591	3,142,029	$	2,498,631
Cumulative effect of change in accounting policy		-	2,532	-	(2,596)	38	(26)		(21)
Balance at January 1, 2008, restated		954,959	466,769	(414,947)	1,593	2,133,629	3,142,003		2,498,611
Dividends		-	-	-	-	(340,449)	(340,449)		(270,735)
Net income		-	-	-	-	894,290	894,290		711,165
Increase of unrealized gain on valuation of available-for-sale securities		-	-	-	25,637	-	25,637		20,387
Increase in unrealized gain on valuation of equity method investments		-	-	-	2,790	-	2,790		2,219
Decrease of unrealized loss on valuation of equity method investments		-	-	-	639	-	639		508
Unearned stock compensation		-	-	2,295	-	-	2,295		1,826
Reacquisition of treasury stock		-	-	(194,128)	-	-	(194,128)		(154,376)
Retirement of treasury stock		-	-	379,753	-	(379,753)	-		-
Compensation by treasury stock		-	4,375	2,377	-	-	6,752		5,369
Balance at December 31, 2008	₩	954,959	471,144	(224,650)	30,659	2,307,717	3,539,829	$	2,814,974

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION
Non-Consolidated Statements of Cash Flows

For the years ended December 31, 2008 and 2007

In millions of Won, and thousands of US dollars		2008 Korean Won		2008 U.S. dollars (note 3)		2007 Korean Won
Cash flows from operating activities						
Net income	₩	894,290	$	711,165	₩	661,206
Adjustments for:						
Depreciation and amortization		134,702		107,119		135,503
Gain on valuation of inventories, net		(14,026)		(11,153)		(4,987)
Loss (gain) on sale of available-for-sale securities		(84)		(67)		724
Bad debt expense		12,491		9,933		6,074
Loss on impairment of available-for-sale securities		-		-		2,150
Gain on valuation of equity method investments, net		(134,706)		(107,122)		(103,315)
Gain on foreign currency translation, net		(25,381)		(20,184)		(2,361)
Provision for retirement and severance benefits		47,071		37,432		31,014
Loss on valuation of derivative investments		2,699		2,146		25
Gain on sale of property, plant and equipment, net		(11,191)		(8,899)		(5,489)
Provision for Tobacco Production Stabilization Fund		-		-		35,516
Amortization of present value discounts		-		-		(11,416)
Others, net		474		377		(664)
		12,049		9,582		82,774
Change in assets and liabilities						
Trade accounts receivable		(124,094)		(98,683)		(35,891)
Other receivables		(40,229)		(31,991)		(9,623)
Advance payments		(21,053)		(16,742)		1,247
Prepaid expenses		2,126		1,691		(3,716)
Inventories		(76,629)		(60,938)		42,014
Trade accounts payable		17,865		14,207		286
Other payables		40,576		32,267		77,559
Advance receipts		(838)		(666)		(2,404)
Withholdings		2,389		1,900		(4,155)
Value added tax withholdings		(3,683)		(2,929)		(11)
Accrued expenses		6,941		5,520		9,940
Tobacco excise tax and dues payable		(13,311)		(10,585)		126,346
Income taxes payable		(29,996)		(23,854)		22,330
Deferred income taxes		11,755		9,348		24,540
Deposit for severance benefits trust		117,822		93,695		(22,351)
Gain on dividend of equity method investments		60,000		47,714		20,000
Payments of retirement and severance benefits		(96,681)		(76,883)		(13,754)
Payments to Tobacco Production Stabilization Fund		-		-		(110,000)
Retirement pension plan asset		(84,959)		(67,562)		-
Others, net		(17)		(14)		(670)
Net cash provided by operating activities	₩	674,323	$	536,242	₩	865,667

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Cash Flows, Continued

For the years ended December 31, 2008 and 2007

In millions of Won, and thousands of US dollars	**2008** Korean Won	**2008** U.S. dollars (note 3)	**2007** Korean Won
Cash flows from investing activities			
Proceeds from sale of available-for-sale securities	₩ 530	$ 421	₩ 1,750
Decrease in long-term loans to employees, net	7,404	5,889	101,321
Increase in long-term loans to affiliates, net	(10,121)	(8,049)	(34)
Increase in guarantee deposits paid, net	(2,698)	(2,146)	(941)
Proceeds from sale of property, plant & equipment	21,867	17,389	26,617
Purchases of available-for-sale securities	(21,928)	(17,438)	(242,324)
Increase in long-term deposit in Escrow Fund	(17,895)	(14,231)	(20,415)
Purchases of property, plant & equipment	(141,086)	(112,196)	(220,962)
Purchases of equity method investment securities	-	-	(18,009)
Other, net	(685)	(544)	(1,033)
Net cash used in investing activities	(164,612)	(130,905)	(374,030)
Cash flows from financing activities			
Decrease in guarantee deposits received, net	(1,908)	(1,517)	(2,921)
Payment of dividends	(340,449)	(270,735)	(319,712)
Reissuance of treasury stock	-	-	235,233
Reacquisition of treasury stock	(194,128)	(154,376)	(455,035)
Net cash used in financing activities	(536,485)	(426,628)	(542,435)
Net decrease in cash and cash equivalents	(26,774)	(21,291)	(50,798)
Cash and cash equivalents at beginning of year	115,126	91,551	165,924
Cash and cash equivalents at end of year	₩ 88,352	$ 70,260	₩ 115,126

See accompanying notes to non-consolidated financial statements.

1. Organization and Description of Business

KT&G Corporation (the "Company"), which is engaged in manufacturing and selling tobacco, was established on April 1, 1987 as Korea Monopoly Corporation, a wholly-owned enterprise of the Korean government, pursuant to the Korea Monopoly Corporation Act, in order to secure financing and to promote and develop, through efficient management, the monopoly business of red ginseng and tobacco. On April 1, 1989, the Company changed its name to Korea Tobacco and Ginseng Corporation pursuant to the Korea Tobacco and Ginseng Corporation Act. Also, pursuant to the Act on Management Reform and Privatization of Public Enterprises, proclaimed on August 28, 1997 and enforced on October 1, 1997, the Company was excluded from the application of the Act for the Management of Government Invested Enterprises. Accordingly, the Company became an entity existing and operating under the Commercial Code of Korea. The Korean government sold 28,650,000 shares of the Company to the public during 1999 and the Company listed its stock on the Korea Stock Exchange on October 8, 1999. On December 27, 2002, the Company changed its name again to KT&G Corporation from Korea Tobacco and Ginseng Corporation.

As of December 31, 2008, the Company has four manufacturing plants, including the Shin Tan Jin plant, and 14 local headquarters and 168 branches for the sale of tobacco throughout the country. Also, the Company has the Gimcheon plant for fabrication of leaf tobacco and the Chunahn printing plant for the manufacturing of packaging

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

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

The ownership of the Company's issued common stock at December 31, 2008 is held as follows:

Stockholder	Number of shares	Percentage of ownership
Industrial Bank of Korea	9,510,485	6.85%
Employee Stock Ownership Association	7,236,217	5.21%
Treasury stock	10,093,697	7.27%
Others	111,952,098	80.67%
	138,792,497	100.00%

The Company has, thus far, reacquired and retired 52,199,400 shares of treasury stock. Accordingly, as of December 31, 2008, the Company's common stock differs from the aggregate par value of issued shares by ₩260,997 million.

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

(a) Basis of Presenting Financial Statements

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

Certain information included in the Korean language non-consolidated financial statements, but not required for a fair presentation of the Company's financial position, results of operations, changes in equity or cash flows, is not presented in the accompanying non-consolidated financial statements.

Except for the items explained in note 31 related to accounting changes and the adoption of changes to Statements of Korean Accounting Standards ("SKAS") No.15 *Investments in Associates*, No.16 *Income Taxes* and Korea Accounting Institute Opinion 06-2 (Deferred Income Taxes on Investments in Subsidiaries, Associates and Interests in Joint Ventures), the Company applied the same accounting policies that were adopted in the previous year's non-consolidated financial statements.

(b) Cash Equivalents

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

(c) Short-term Deposits

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

(d) Allowance for Doubtful Accounts

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

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

(e) Inventories

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-progress; using the moving-average method for raw materials and supplies; and using the specific identification method for goods-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. Amounts of inventory written down to net realizable value due to losses occurring in the normal course of business are recognized as cost of goods sold and are deducted as an allowance from the carrying value of inventories. The Company recognized loss and reversal of loss on valuation of inventories amounting to ₩4,413 million and ₩18,439 million, respectively, for the year ended December 31, 2008. Also, the estimated amounts of inventories in current assets, which will not be realized in a year or less, are ₩304,969 million and ₩319,217 million, respectively, as of December 31, 2008 and 2007.

(f) Investment in Securities (Excluding Investments in Associates, Subsidiaries and Joint Ventures)

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

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

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

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

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

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

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

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

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

(g) Investment Securities under the Equity Method of Accounting

Associates are entities of which the Company and its subsidiaries have the ability to significantly influence the financial and operating policies. It is presumed to have significant influence if the Company holds directly or indirectly 20 percent or more of the voting power unless it can be clearly demonstrated that this is not the case. Subsidiaries are entities controlled by the Company.

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

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

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

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

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

(g) Investment Securities under the Equity Method of Accounting, Continued

When applying the equity method of accounting to a subsidiary, except when the Company's share of losses in subsidiary equals or exceeds its interest in subsidiary, net income and net assets of non-consolidated financial statements must agree with those of consolidated financial statements.

(h) Property, Plant and Equipment

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

Significant additions or improvements extending useful lives of assets are capitalized. However, normal maintenance and repairs are charged to expense as incurred.

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

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

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

The Company reviews property, plant and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss would be recognized when the expected estimated undiscounted future net cash flows from the use of the asset and its eventual disposal are less than its carrying amount.

(i) Intangible Assets

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

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

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

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

(i) Intangible Assets, Continued

(i) Research and Development Costs

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

(ii) Other Intangible Assets

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

(j) Retirement and Severance Benefits

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

The Company introduced a new pension plan, from 2008. Under the Retirement Benefits Regulation, consideration of service requirements under the new plan begins from the date the new plan is effective; the period of service prior to the effective date of the new plan will continue to be covered by the existing retirement benefits plan.
The Company introduced a defined benefit pension plan, under which each eligible employee receives a fixed amount of pension after retirement. The Company accrued, as a liability for retirement and severance benefits, lump-sum payments payable to employees who are currently in service, assuming that they left the Company as of the balance sheet date. All employees with a minimum of one year of service are eligible to participate and must elect to participate in the plan. Participants accrue estimated benefits based on actuarial assumptions measured on the balance sheet date at the discounted present value.

The combined provision for retirement and severances benefits under the new pension plan and those under the existing retirement benefits plan is recorded as the liability for retirement and severance benefits. Pension plan assets, together with the existing retirement and severance benefit deposit and the deposit previously made to the National Pension Fund under the old National Pension Law, as referred to above, is reflected in the accompanying balance sheets as a reduction of the liability for retirement and severance benefits.

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

(k) Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at the balance sheet date, with the resulting gains or losses recognized in current results of operations. Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at ₩1,257.5 to USD1, the rate of exchange on December 31, 2008 that is permitted by the Financial Accounting Standards. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Korean Won at the foreign exchange rate on the date of the transaction.

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

(l) Revenue Recognition

The Company's revenue categories consist of tobacco products sold, construction contracts and other income.

Tobacco products sold
Revenue from the sale of tobacco products is measured at the fair value of the consideration received or receivable, net of returns and allowances, trade discounts and volume rebates. Revenue is recognized when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, the associated costs and possible return of goods can be estimated reliably, and there is no continuing management involvement with the goods.

Lotting-out construction contracts
As soon as the outcome of a lotting-out construction contract can be estimated reliably, contract revenue and expenses are recognized in the statement of income in proportion to the percentage of completion and sales in lots of the contact. Lotting-out revenue 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.

The percentage of completion is assessed by reference to costs incurred for work performed to date to the estimated total contract costs. When the outcome of a construction contract cannot be estimated reliably, revenue is recognized only to the extent of contract costs incurred that are likely to be recoverable. An expected loss on a contract is recognized immediately in the statement of income.

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

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

(m) Income Taxes

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

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

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

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

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

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

(n) Provisions, Contingent Assets and Contingent Liabilities

Provisions are recognized when all of the following are met: (1) an entity has a present obligation as a result of a past event, (2) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and (3) a reliable estimate can be made of the amount of the obligation. Where the effect of the time value of money is material, a provision is recorded at the present value of the expenditures expected to be required to settle the obligation.

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

(o) Earnings Per Share

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

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

(p) Share-based Payments

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

(q) Derivatives

The Company holds derivative financial instruments to hedge its foreign currency and interest rate risk exposures. Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, and a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

Derivatives are initially recognized at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at their fair value. Attributable transaction costs are recognized in profit or loss when incurred.

Hedge accounting
Where a derivative, which meets certain criteria, is used for hedging the exposure to changes in the fair value of a recognized asset, liability or firm commitment, it is designated as a fair value hedge. Where a derivative, which meets certain criteria, is used for hedging the exposure to the variability of the future cash flows of a forecasted transaction it is designated as a cash flow hedge.

The Company documents, at the inception of the transaction, the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting the changes in fair values or cash flows of hedged items.

Fair value hedge
Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the statement of income, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

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

(q) Derivatives, Continued

Cash flow hedge
The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognized in equity. The gain or loss relating to any ineffective portion is recognized immediately in the statement of income. Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at the time remains in equity and is recognized when the forecast transaction is ultimately recognized in the statement of income. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the statement of income.

Derivatives that do not qualify for hedge accounting
Changes in the fair value of derivative instruments that are not designated as fair value or cash flow hedges are recognized immediately in the statement of income.

Separable embedded derivatives
Changes in the fair value of separable embedded derivatives are recognized immediately in the statement of income.

(r) Use of Estimates

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

3. Basis of Translating Financial Statements

The non-consolidated financial statements are expressed in Korean Won and have been translated into U.S. dollars at the rate of ₩1,257.5 to US$1, the basic exchange rate on December 31, 2008, solely for the convenience of the reader. This translation should not be construed as a representation that any or all of the amounts shown could be converted into United States dollars at this or any other rate.

4. Inventories

Inventories as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Finished goods, net of allowance for valuation losses	₩	78,473	80,680
Work-in-process		10,039	10,100
Raw materials, net of allowance for valuation losses		816,773	792,561
Supplies		22,978	21,507
By-products		3,241	2,641
Completed buildings		121,552	52,150
Sites for building lotting-out construction (notes 10 and 21)		12,728	13,204
Goods-in-transit		9,728	6,670
	₩	1,075,512	979,513

5. Other Current Assets

Other current assets as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Accrued income	₩	287	237
Other receivables, net of allowance for doubtful accounts of ₩5,605 in 2008 and ₩4,652 in 2007 (note 16)		73,048	33,564
Prepaid expenses		4,880	7,006
Short-term loans to employees (note 8)		28,029	19,442
Advance payments (note 8)		21,297	244
Available-for-sale securities (note 6)		2,149	92
	₩	129,690	60,585

6. Available-for-sale Securities

Available-for-sale securities as of December 31, 2008 and 2007 are summarized as follows:

(a) Equity securities (non-current)

In millions of Won, except owned shares and percentage of ownership	Number of shares	Percentage of ownership		Acquisition cost	Fair value	Book value 2008	Book value 2007
Marketable securities:							
Yonhap Television News (YTN)	8,380,000	19.95%	₩	5,102	37,249	37,249	28,366
Crystal Genomics Co., Ltd.	172,187	1.67%		3,022	1,722	1,722	1,791
Oscotech, Inc.	230,770	3.51%		2,250	748	748	1,396
Shinhan Financial Group	3,500,000	0.88%		205,532	103,950	103,950	187,250
REXAHN Pharmaceuticals, Inc. (*1)	4,642,858	8.28%		5,158	5,196	5,196	-
Celltrion, Inc. (*2)	13,030,810	12.22%		21,245	129,005	129,005	-
				242,309	277,870	277,870	218,803
Non-marketable securities:							
Celltrion, Inc. (*2)	-	-		-	-	-	21,245
Nexgen Biotechnologies, Inc. (*3)	1,000,000	11.84%		2,150	-	-	-
Cosmo Tobacco Co., Ltd. (*3)	480,000	40.00%		2,540	-	-	-
Innodis, Inc.	110,000	19.64%		55	55	55	55
REXAHN Pharmaceuticals, Inc. (*1)	-	-		-	-	-	5,158
Lifenza, Inc. (*3)	29,047	13.01%		1,600	-	-	-
Korea Islet Transplantation Institute, Inc. (*4)	110,500	48.25%		2,000	2,000	2,000	2,000
KT&G Mongolia LLC (*5)	-	-		-	-	-	201
Korea Tabacos do Brasil Ltda. (*4)	(*6)	99.90%		394	394	394	394
Genematrix, Inc.	300,000	10.14%		1,500	1,500	1,500	1,500
Litepharmtech, Inc. (*4)	77,667	29.46%		1,830	1,830	1,830	1,830
Hurum, Inc.	7,800	9.75%		39	39	39	39
Mazence Co., Ltd. (formerly, MD Bioalpha Co., Ltd.)	197,556	6.86%		733	733	733	733
OCT USA, Inc.	48,780	19.97%		927	927	927	927
Dream Hub PFV Co., Ltd.	3,000,000	1.50%		15,000	15,000	15,000	75
Migami, Inc.	4,286,000	3.77%		2,830	2,830	2,830	-
KT&G Pars (*4)	1,577,754	99.99%		1,697	1,697	1,697	-
KT&G Rus L.L.C. (*4)	(*6)	100.00%		802	802	802	-
Korean Carbon Finance Co., Ltd. (*4)	100,000	20.00%		500	500	500	-
SJ Biomed Corporation	285,714	14.39%		1,000	1,000	1,000	-
				35,597	29,307	29,307	34,157
Total			₩	277,906	307,177	307,177	252,960

6. Available-for-sale Securities, Continued

(a) Equity securities (non-current), Continued

(*1) As REXAHN Pharmaceuticals, Inc. was listed on New York Stock Exchange in the year ended December 31, 2008, REXAHN Pharmaceuticals, Inc. is recorded at the reasonably adjusted value of the market price established in New York Stock Exchange.
(*2) As Celltrion, Inc. was Listed on KOSDAQ in the year ended December 31, 2008, Celltrion, Inc. is recorded at the market price established in KOSDAQ.
(*3) In the prior period, the Company wrote off its investments in Nexgen Biotechnologies, Inc., Lifenza, Inc. and Cosmo Tobacco Co., Ltd. as its decline in value was judged to be other than temporary. Other than the above, non-marketable securities are recorded at cost since fair value is not available or readily determinable.
(*4) Investments in small affiliates are accounted for under the cost method of accounting for investments since the effect of applying the equity method on its financial statements is not material.
(*5) The liquidation process was completed in the year ended December 31, 2008, the Company recorded a gain of ₩80 million on sale of available-for-sale securities.
(*6) Stock certificates are not issued.

(b) Debt securities

In millions of Won	Interest rate per annum		Acquisition cost	Fair value	Book value 2008	Book value 2007
Current assets:						
Government and municipal bonds	2.5 ~ 4.0%	₩	149	149	149	92
Oscotech, Inc.	10.0%		1,000	1,000	1,000	-
Litepharmtech, Inc.	8.0%		1,000	1,000	1,000	-
			2,149	2,149	2,149	92
Non-current assets:						
Government and municipal bonds	2.5%	₩	2,001	2,001	2,001	2,129
Oscotech, Inc.	-		-	-	-	1,000
Litepharmtech, Inc.	-		-	-	-	1,000
			2,001	2,001	2,001	4,129
		₩	4,150	4,150	4,150	4,221

The Company recorded ₩20 million of interest income on debt securities for the year ended December 31, 2008.

6. Available-for-sale Securities, Continued

(c) Changes in unrealized gains

(i) Changes in unrealized gains of valuation of available-for-sale securities for the year ended December 31, 2008 are summarized as follows:

In millions of Won		Amount including tax effect	Tax effect	Amount, net of tax effect
Beginning balance	₩	2,897	(797)	2,100
Changes in unrealized gain		32,664	(7,027)	25,637
Ending balance	₩	35,561	(7,824)	27,737

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

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

7. Equity Method Investment Securities

(a) Investments in companies accounted for using the equity method as of December 31, 2008 were as follows:

In millions of Won, except percentage of ownership

Company	Percentage of ownership		Cost	Market value or net assets	Balance at December 31, 2008
Listed					
Yungjin Pharm. Ind. Co., Ltd. (*1)	55.50%	₩	50,691	51,211	20,493
Unlisted					
Korea Ginseng Corporation	100.00%		214,929	646,905	646,905
Tae-a Industry Co., Ltd.	100.00%		14,198	6,808	7,559
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. (*1)	99.99%		33,670	30,533	30,329
		₩	313,488	735,457	705,286

(*1) The Company used unaudited financial statements of Yungjin Pharm. Ind. Co., Ltd. and KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. when applying the equity method of accounting.

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

In millions of Won, percentage of ownership

Company	Percentage of ownership		Cost	Market value or net assets	Balance at December 31, 2007
Listed					
Yungjin Pharm. Ind. Co., Ltd. (*1)	55.50%	₩	50,691	97,169	23,941
Unlisted					
Korea Ginseng Corporation	100.00%		214,929	559,883	559,883
Tae-a Industry Co., Ltd.	100.00%		14,198	6,229	9,174
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. (*1,2)	99.99%		33,670	33,670	33,670
		₩	313,488	696,951	626,668

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

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

7. Equity Method Investment Securities, Continued

(b) Details of the difference between the acquisition cost and the Company's share of the investees' identifiable net assets arisen in the years ended December 31, 2008 and 2007 were as follows:

In millions of Won		2008 Beginning balance	2008 Amortized amount	2008 Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩	897	(896)	1
Tae-a Industry Co., Ltd.		3,109	(2,073)	1,036
	₩	4,006	(2,969)	1,037

In millions of Won		2007 Beginning balance	2007 Amortized amount	2007 Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩	1,793	(896)	897
Tae-a Industry Co., Ltd.		5,183	(2,074)	3,109
	₩	6,976	(2,970)	4,006

(c) Details of unrealized gains from intercompany transactions for the years ended December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008 Beginning balance	2008 Increase	2008 Realized amount	2008 Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩	2,017	84	(25)	2,076
Tae-a Industry Co., Ltd.		164	1,626	(1,505)	285
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		-	305	(101)	204
	₩	2,181	2,015	(1,631)	2,565

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

7. Equity Method Investment Securities, Continued

(d) Changes in the begining and ending balances of investments in companies accounted for using the equity method for the years ended December 31, 2008 and 2007 were as follows:

In millions of Won, except percentage of ownership

Company	Percentage of ownership		2008 Balance at January 1, 2008	Net income (loss)	Accumlated other Compre-hensive income	Other decrease (*1)	Balance at December 31, 2008
Korea Ginseng Corporation	100.00%	₩	559,883	145,046	1,976	(60,000)	646,905
Yungjin Pharm. Ind. Co., Ltd	55.50%		23,941	(3,448)	-	-	20,493
Tae-a Industry Co., Ltd.	100.00%		9,174	(1,615)	-	-	7,559
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	99.99%		33,670	(5,277)	1,936	-	30,329
		₩	626,668	134,706	3,912	(60,000)	705,286

(*1) The amount was cash dividends.

In millions of Won, except percentage of ownership

Company	Percentage of ownership		2007 Balance at January 1, 2007	Net income (loss)	Accumlated other Compre-hensive income	Other increase (decrease) (*1)	Balance at December 31, 2007
Korea Ginseng Corporation	100.00%	₩	451,545	128,302	36	(20,000)	559,883
Yungjin Pharm. Ind. Co., Ltd. (*3)	55.50%		27,871	(23,633)	-	19,703	23,941
Tae-a Industry Co., Ltd.	100.00%		10,528	(1,354)	-	-	9,174
KT&G USA, Inc (*2)	-		903	-	-	(903)	-
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	99.99%		-	-	-	33,670	33,670
		₩	490,847	103,315	36	32,470	626,668

(*1) The amount consists of ₩20,000 million cash dividends, ₩53,373 million paid-in capital increase and ₩903 million reclassification.

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

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

7. Equity Method Investment Securities, Continued

(e) Summarized financial information of equity-accounted investment securities, which represents 100% of the entities' balances as of December 31, 2008 was as follows:

In millions of Won

Company		Total assets	Total liabilities	Sales	Net income (loss)
Korea Ginseng Corporation	₩	752,330	105,425	622,066	145,046
Yungjin Pharm. Ind. Co., Ltd.		109,320	68,657	110,868	(6,485)
Tae-a Industry Co., Ltd.		11,107	4,299	15,321	579
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		56,506	25,973	2,832	(5,073)

Summarized financial information of equity-accounted investment securities, which represents 100% of the entities' balances as of December 31, 2007 was as follows:

In millions of Won

Company		Total assets	Total liabilities	Sales	Net income (loss)
Korea Ginseng Corporation	₩	631,874	71,991	521,123	128,302
Yungjin Pharm. Ind. Co., Ltd.		106,912	61,759	109,422	(16,575)
Tae-a Industry Co., Ltd.		10,298	4,069	13,419	767
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		37,973	4,303	-	(1,608)

8. Transactions and Balances with Related Companies

(a) The Company's subsidiaries as of December 31, 2008 were as follows:

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

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

8. Transactions and Balances with Related Companies, Continued

(b) Significant transactions and account balances which occurred in the normal course of business with related companies as of and for the years ended December 31, 2008 and 2007 are summarized as follows:

(i) Revenue from sales and others

In millions of Won

Company		2008 Sales	2008 Other income	2008 Total	2007 Sales	2007 Other income	2007 Total
Korea Ginseng Corporation	₩	12 ,176	1,095	13,271	1,440	11,545	12,985
Yungjin Pharm. Ind. Co., Ltd.		163	8	171	202	1	203
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		2,512	682	3,194	1,186	680	1,866
KT&G USA, Inc.		-	-	-	1,694	-	1,694
KT&G Mongolia LLC		-	-	-	1,457	-	1,457
KT&G Pars		556	965	1,521	-	-	-
	₩	15,407	2,750	18,157	5,979	12,226	18,205

(ii) Purchases and other expenses

In millions of Won

Company		2008 Purchases	2008 Other expenses	2008 Total	2007 Purchases	2007 Other expenses	2007 Total
Korea Ginseng Corporation	₩	-	1,446	1,446	2,223	-	2,223
Yungjin Pharm. Ind. Co., Ltd.		-	121	121	144	-	144
Tae-a Industry Co., Ltd.		15,321	-	15,321	13,419	-	13,419
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		-	-	-	1,092	494	1,586
Korea Tabacos do Brasil Ltda.		-	165	165	-	132	132
	₩	15,321	1,732	17,053	16,878	626	17,504

(iii) Due from affiliates

In millions of Won

Company		2008 Trade accounts receivable	2008 Other	2008 Total	2007 Trade accounts receivable	2007 Other	2007 Total
Korea Ginseng Corporation	₩	-	3,184	3,184	-	-	-
KT&G Tutun MamulleriSanayi ve Ticaret A.S.		1,313	24,128	25,441	1,127	-	1,127
KT&G Pars		11	7,193	7,204	-	-	-
KT&G Rus L.L.C		-	347	347	-	-	-
KT&G Mongolia LLC		-	-	-	316	238	554
	₩	1,324	34,852	36,176	1,443	238	1,681

8. Transactions and Balances with Related Companies, Continued

(iv) Due to affiliates

In millions of Won		2008			2007		
Company		**Trade accounts payable**	**Other**	**Total**	**Trade accounts payable**	**Other**	**Total**
Korea Ginseng Corporation	₩	-	2,595	2,595	270	2,379	2,649

(c) Due from stockholders, directors and employees as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Loans for employee housing and education	₩	30,660	31,713
Loans to Employee Stock Ownership Association		28,388	37,664
Other		48,929	46,004
	₩	107,977	115,381

(d) Key management personnel compensation in total and for each of the following categories for the years ended December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Short-term payroll	₩	8,698	11,609
Post-retirement pay		9,113	4,081
	₩	17,811	15,690

9. Property, Plant and Equipment

Property, plant and equipment at December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Property, plant and equipment at cost	₩	2,266,480	2,224,880
Accumulated depreciation		(867,664)	(815,881)
Accumulated impairment losses		(41)	(41)
Property, plant and equipment, net	₩	1,398,775	1,408,958

9. Property, Plant and Equipment, Continued

(a) Changes in property, plant and equipment for the year ended December 31, 2008 were as follows:

In millions of Won		January 1, 2008	Acquisition	Disposal	Depreciation	Others (*1)	December 31, 2008
Land	₩	403,344	1,304	(2,366)	-	16,567	418,849
Buildings		470,731	8,983	(3,175)	(23,159)	22,654	476,034
Structures		23,340	737	(144)	(2,078)	1,284	23,139
Machinery and equipment		342,473	11,173	(4,513)	(66,458)	57,083	339,758
Vehicles and other transportation equipment		2,836	575	(12)	(1,702)	-	1,697
Tools		11,640	612	(11)	(4,757)	3,061	10,545
Furniture and fixtures		75,328	20,851	(455)	(35,842)	1,981	61,863
Construction-in-progress (*2)		78,663	96,851	-	-	(109,227)	66,287
Other tangible fixed assets		603	-	-	-	-	603
	₩	1,480,958	141,086	(10,676)	(133,996)	(6,597)	1,398,775

(*1) Other changes in property, plant and equipment, except those transferred from construction-in-progress, for the year ended December 31, 2008 were as follows:

In millions of Won		Amount
Transferred to site for building lotting-out construction	₩	(5,970)
Loss on impairment of property, plant and equipment		(429)
Transferred to intangible assets (note 11)		(198)
	₩	(6,597)

(*2) Construction-in-progress as of December 31, 2008 included investment on development of new medicines amounting to ₩25,456 million.

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

In millions of Won		January 1, 2007	Acquisition	Disposal	Depreciation	Others (*1)	December 31, 2007
Land	₩	353,865	21,961	(13,592)	-	41,110	403,344
Buildings		460,511	6,088	(4,415)	(21,570)	30,117	470,731
Structures		23,194	1,076	(263)	(1,971)	1,304	23,340
Machinery and equipment		332,553	7,220	(2,479)	(67,408)	72,587	342,473
Vehicles and other transportation equipment		5,322	546	(225)	(2,883)	76	2,836
Tools		10,010	2,106	(27)	(4,497)	4,048	11,640
Furniture and fixtures		75,235	32,493	(127)	(36,443)	4,170	75,328
Construction-in-progress (*2)		83,002	149,333	-	-	(153,672)	78,663
Other tangible fixed assets		464	139	-	-	-	603
	₩	1,344,156	220,962	(21,128)	(134,772)	(260)	1,408,958

9. Property, Plant and Equipment, Continued

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

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

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

10. Officially Declared Value of Land

The officially declared value of land at December 31, 2008 and 2007, as announced by the Minister of Construction and Transportation, were as follows:

		2008		2007	
In millions of Won		Book value	Declared value	Book value	Declared value
Land	₩	418,849	1,408,474	403,344	1,304,163
Sites for building lotting-out construction		12,728	50,555	13,204	40,356
	₩	431,577	1,459,029	416,548	1,344,519

The officially declared value, which is used for government purposes, is not intended to represent fair value.

11. Intangible Assets

(a) Changes in intangible assets for the year ended December 31, 2008 were as follows:

In millions of Won		Industrial property rights	Other intangible assets	Total
Beginning balance	₩	1,520	199	1,719
Increases		198	-	198
Amortization		(613)	(93)	(706)
Other		-	(23)	(23)
Net balance at end of period	₩	1,105	83	1,188

11. Intangible Assets, Continued

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

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

12. Insurance

Buildings, structures, machinery and equipment and inventories were insured against fire damage up to ₩899,418 million as of December 31, 2008 with Dongbu Insurance Co., Ltd. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

13. Other Non-Current Assets

Other non-current assets as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Long-term loans to affiliates (notes 8 and 16)	₩	10,630	238
Long-term other receivables, net of allowance for doubtful accounts of ₩6 in 2008 and ₩10 in 2007		555	1,018
Other investments assets		419	677
	₩	11,604	1,933

14. Other Current Liabilities

Other current liabilities as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Withholdings	₩	8,632	6,244
Advance receipts		3,871	4,709
Current portion of financial derivative liabilities (note 32)		2,699	25
Unearned income		379	321
	₩	15,581	11,299

15. Retirement and Severance Benefits

Changes in the retirement and severance benefits for the years ended December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Estimated retirement and severance benefits accrual at beginning of year	₩	182,345	173,332
Provision for retirement and severance benefits		47,071	31,014
Transferred to unearned stock compensation		(2,295)	-
Payments (*1)		(103,481)	(22,001)
Estimated retirement and severance benefits accrual at end of year		123,640	182,345
Retirement pension plan asset (*2)		(84,959)	-
Deposit for severance benefits trust		(164)	(117,985)
Net balance at end of year	₩	38,517	64,360

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

(*1) Compensations paid by treasury stock amounting to ₩2,430 million for the year ended December 31, 2008 were included.

(*2) Retirement pension plan asset as of December 31, 2008 was as follows:

In millions of Won		Amount
Short-term financial instruments	₩	49,573
Available-for-sale securities		35,386
	₩	84,959

16. Assets and Liabilities Denominated in Foreign Currencies

Details of assets and liabilities denominated in foreign currencies as of December 31, 2008 and 2007 were as follows:

In millions of Won, In thousands of US dollars and Euro		Foreign currency			Korean Won equivalent	
		2008	2007		2008	2007
Assets:						
Cash and cash equivalents	USD	888	9,107	₩	1,116	8,544
	EUR	47	-		83	-
Trade accounts receivable	USD	212,002	159,875		266,592	149,995
	EUR	746	816		1,325	1,127
Other receivables	USD	3,259	259		4,098	243
Long-term loans to affiliates	USD	8,453	-		10,630	-
Long-term deposits in escrow fund	USD	87,683	71,022		110,261	66,633
Total	USD	312,285	240,263		392,697	225,415
	EUR	793	816		1,408	1,127
				₩	394,105	226,542
Liabilities:						
Trade accounts payable	USD	266	692	₩	335	649
	EUR	4,100	2,530		7,282	3,495
				₩	7,617	4,144

17. Capital Adjustments

Capital adjustments as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Treasury stock	₩	(226,945)	(414,947)
Unearned stock compensation		2,295	-
	₩	(224,650)	(414,947)

18. Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Unrealized gain on valuation of available-for-sale securities (note 6)	₩	27,737	2,100
Unrealized gain on valuation of equity method investments (note 7)		2,922	132
Unrealized loss on valuation of equity method investments (note 7)		-	(639)
	₩	30,659	1,593

19. Retained Earnings

Retained earnings as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Legal reserve	₩	602,937	602,937
Reserve for business expansion		698,881	698,881
Reserve for business rationalization		12,851	12,851
Reserve for research and human resource development		30,000	45,000
Reserve for loss on reissuance of treasury stock		26,646	26,646
Other appropriations		420,000	350,000
Unappropriated retained earnings at end of year		516,402	397,314
	₩	2,307,717	2,133,629

(a) Legal Reserve

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

(b) Reserve for Business Expansion

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

(c) Reserve for Business Rationalization

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

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

(d) Other Reserves

Reserves for research and human resource development and loss on reissuance of treasury stock were appropriated in order to utilize certain tax deduction benefits through the early recognition of future expenditures. These reserves are restored to retained earnings in accordance with the relevant tax laws. Such reserves are taken back into taxable income in the year of restoration. Reserves without specific purposes are restored to retained earnings by a resolution at a general meeting of stockholders.

20. Commitments and Contingencies

The Company recorded as a long-term deposit the amounts paid into the escrow funds of State governments in the United States against potential litigation and damages related to the export of tobacco into the United States. The escrow funds will be refunded if the Company did not indemnify the State governments for damages for a specified number of years on the grounds that the Company did not sell cigarettes illegally. As of December 31, 2008 and 2007, the Company made deposits of ₩110,261 million and ₩66,633 million, respectively which were included as long-term deposits in escrow funds in the accompanying non-consolidated balance sheets.

As of December 31, 2008, tobacco lawsuits claiming damages of ₩759 million were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligation to notify smokers of the potential health hazards of smoking. Additionally, the Company is involved in 12 lawsuits and claims for alleged damages totalling ₩16,017 million as of December 31, 2008. The amount of the liability the Company may ultimately have with respect to the litigation cannot be reasonably estimated as of December 31, 2008.

As of December 31, 2008, the Company has provided to the National Agricultural Cooperative Federation ("NACF") and another bank guarantees totaling ₩13,344 million for the customers who made a financing agreement with these lenders.

As of December 31, 2008, the Company has entered into Letter of Credit agreements with the NACF and other banks with a limit set at USD104,000 thousand.

As of December 31, 2008, the Company's trade accounts receivable from the export of cigarettes was insured against nonpayment up to USD34,400 thousand by an export guaranty insurance with the Korea Export Insurance Corporation.

As of December 31, 2008, the Company has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries up to USD90,000 thousand by Korea Exchange Bank and other.

As of December 31, 2008, the Company and 28 other companies, which form the Samsung Corporation-National Pension Service Joint Consortium, were guaranteed ₩240,000 million by Seoul Guarantee Insurance Co. in relation to the Yongsan International Commercial Development Project.

The Company entered into an overdraft agreement with a limit of ₩30,000 million with the NACF as of December 31, 2008.

21. Building Lotting-out Construction Contracts

(a) Building lotting-out construction contracts as of December 31, 2008 are summarized as follows:

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

(b) Details of installment sales as of December 31, 2008 are summarized as follows:

In millions of Won		Expected contract amount	Confirmed contract amount	Recognized revenue Prior to 2008	Recognized revenue 2008	Unrecognized revenue
Apartment buildings in Jeonju	₩	284,995	86,525	20,275	62,311	202,409
Apartment buildings in Daejeon		44,047	25,376	-	9,664	34,383
	₩	329,042	111,901	20,275	71,975	236,792

(c) Cost of installment sales of store units for the years ended December 31, 2008 and 2007 were as follows:

In millions of Won		Prior to 2008	2008	Aggregate amount
Apartment buildings in Jeonju	₩	13,726	42,270	55,996
Apartment buildings in Daejeon		-	6,680	6,680
	₩	13,726	48,950	62,676

22. Income Taxes

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

Taxable income		Tax rate			
Prior to 2008	**Thereafter**	**Prior to 2008**	**2008**	**2009**	**Thereafter**
Up to ₩100 million	Up to ₩200 million	14.3%	12.1%	12.1%	11.0%
Over ₩100 million	Over ₩200 million	27.5%	27.5%	24.2%	22.0%

In December 2008, the Korean government reduced the corporate income tax rate (including resident tax) and increased the tax base from ₩100 million to ₩200 million beginning in 2008. Effective January 1, 2008, the income tax rate for those whose taxable income is less than ₩ 200 million was reduced from 14.3 % to 12.1%.

(b) The components of income tax expense for the years ended December 31, 2008 and 2007 are summarized as follows:

In millions of Won		**2008**	**2007**
Current income tax expense	₩	275,258	270,497
Deferred income tax expense		20,924	18,744
Income tax expense charged directly to stockholders' equity		(9,169)	(43,344)
Income tax charge	₩	287,013	245,897

(c) Deferred tax assets and liabilities are measured using the tax rate to be applied for the year in which temporary differences are expected to be realized, and the change in deferred tax assets (liabilities) due to the change in the income tax rate amounting to ₩26,901 of which ₩261 was recognized directly to equity and ₩26,640 was recognized in current income tax expense.

(d) The charge for income taxes calculated by applying statutory tax rates differs from the actual charge for the years ended December 31, 2008 and 2007 for the following reasons:

In millions of Won		**2008**	**2007**
Expense for income taxes at normal tax rates	₩	324,834	249,437
Tax effects of permanent differences		(12,906)	(2,070)
Tax credit		(4,627)	(8,026)
Changes in valuation allowances for deferred income tax assets (liabilities) arisen from equity in income of affiliates		9,744	6,279
Effect from change in tax rate		(29,799)	-
Additional income taxes for prior period (Refund of prior year's income taxes)		(233)	277
Income tax expense	₩	287,013	245,897

(e) The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 24.3% and 27.1% for the years ended December 31, 2008 and 2007.

22. Income Taxes, Continued

(f) The Company did not recognize a deferred tax asset in the amount of ₩39,974 million and ₩31,749 million arising from the taxable temporary differences associated with affiliates as of December 31, 2008 and 2007, respectively, since there is a remote possibility that the Company will dispose of its investments in affiliates in the foreseeable future.

(g) Deferred tax assets and liabilities that were directly charged or credited to accumulated other comprehensive income as of December 31, 2008 and 2007 were as follows:

In millions of Won		2008	2007
Gain on reissuance of treasury stock	₩	(1,659)	(48,864)
Unrealized gain on valuation of available-for-sale securities		(7,027)	5,245
Unrealized gain (loss) on valuation of equity method investments		(483)	275
	₩	(9,169)	(43,344)

(h) Under SKAS No. 16, *Income Taxes*, the deferred tax amounts should be presented as a net current asset or liability and a net non-current asset or liability. In addition, the Company is required to disclose aggregate deferred tax assets (liabilities). As of December 31, 2008, details of aggregate deferred tax assets (liabilities) were as follows:

In millions of Won		**Temporary differences at December 31, 2008**	**Deferred tax assets (liabilities)**	
			Current	**Non-current**
Assets:				
Provision for retirement and severance benefits	₩	97,968	-	21,553
Loss on valuation of inventories		565	137	-
Depreciation		11,429	-	2,514
Bad debts		20,441	4,946	-
Impairment losses on property, plant and equipment		1,334	-	293
Contributions		35,564	8,606	-
Other		19,058	1,744	2,314
		186,359	15,433	26,674
Liabilities:				
Accrued income		(229)	(54)	-
Deposit for severance benefits trust		(85,126)	-	(18,727)
Reserve for research and human resources development		(15,000)	-	(3,300)
Equity method investment securities		(520,365)	-	(117,701)
Reserve for losses on reissuance of treasury stock		(26,646)	-	(5,862)
Available-for-sale securities		(35,562)	-	(7,823)
Treasury stock		(38,930)	-	(8,565)
Gain on foreign currency translation		(25,332)	(6,130)	-
Other		(7,830)	-	(697)
		(755,020)	(6,184)	(162,675)
Net deferred tax asset (liability)	₩	(568,661)	9,249	(136,001)

23. Earnings Per Share

(a) Basic earnings per share

Basic earnings per share for the years ended December 31, 2008 and 2007 are as follows:

In Won		2008	2007
Net income	₩	894,290,228,258	661,205,876,222
Weighted-average number of shares outstanding		130,140,446	132,442,442
Basic earnings per share	₩	6,872	4,992

(b) Potential dilutive securities which are not included in the calculation of diluted earnings per share for the year ended December 31, 2008 are summarized as follows:

Type	Par value in Korean Won	Maturity date	Issuable number of shares
Retirement and severance benefits (share-based payment)	₩ 5,000	February 28, 2009 and 2010	155,519

24. Dividends

(a) Details of dividends for the years ended December 31, 2008 and 2007 were as follows:

In millions of Won		2008	2007
Cash dividends, but not declared	₩	360,357	340,449
Net income	₩	894,290	661,206
Dividends as a percentage of net income		40.30%	51.49%
Par value	₩	643,494	654,710
Dividends as a percentage of par value		56.0%	52.0%

(b) The dividend yield ratios for the years ended December 31, 2008 and 2007 were as follows:

In Won		2008	2007
Dividend per share	₩	2,800	2,600
Market price as of year-end		79,100	79,700
Dividend yield ratio		3.5%	3.3%

25. Non-cash Investing and Financing Activities

Significant non-cash investing and financing activities for the years ended December 31, 2008 and 2007 are summarized as follows:

In millions of Won		2008	2007
Retirement of treasury stock	₩	379,752	269,410
Compensation through treasury stock		5,982	2,999
Severance pay by treasury stock		2,430	8,247

26. Added Value

The components of manufacturing costs and selling and administrative expenses which are necessary in calculating added value for the years ended December 31, 2008 and 2007 are as follows:

In millions of Won		2008	2007
Wages and salaries	₩	314,472	306,787
Provision for severance benefits		47,071	31,014
Employee welfare		41,213	43,830
Rent		16,140	13,322
Depreciation		133,996	134,772
Taxes and dues		26,119	22,887

27. Employee Welfare and Contributions to Society

For employee welfare, the Company maintains a refectory, an infirmary, athletic facilities, a scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spent for the years ended December 31, 2008 and 2007 were estimated at ₩41,213 million and ₩43,830 million, respectively.

The Company donated ₩28,020 million and ₩24,995 million to KT&G Social Welfare Foundation and others for the years ended December 31, 2008 and 2007, respectively.

28. Selling, General and Administrative Expenses

The details of selling, general and administrative expenses for the years ended December 31, 2008 and 2007 were as follows:

In millions of Won		2008	2007
Salaries	₩	190,328	183,268
Provision for severance benefits		33,129	19,883
Welfare		23,788	25,050
Travel		5,986	5,889
Communications		4,326	4,188
Utilities		6,098	6,130
Taxes and dues		23,376	20,178
Supplies		4,307	2,948
Uniforms		62	65
Rent		8,614	5,840
Depreciation		53,656	53,847
Amortization		687	713
Repairs and maintenance		5,322	9,994
Vehicles		8,467	7,098
Insurance		550	561
Commissions		62,972	61,238
Transportation and warehousing		29,465	25,049
Entertainment		358	605
Conferences		3,446	2,634
Advertising		141,148	136,833
Training		7,650	8,111
Prizes and rewards		4,954	1,943
Cooperation		414	700
Normal research and development		15,314	16,402
Sample		5	4
Bad debts		11,543	6,064
Miscellaneous		333	604
	₩	646,298	605,839

29. Share Based Payment

(a) Executives who have been with the Company for more than one year are entitled to severance payment which is based on executives' performance. Eligible executives may choose to receive the Company's shares for their severance payment. The details of the Company's stock compensation plan as of December 31, 2008 were as follows:

In Won

Method of settlement	**Optional share-based payment**
Type	Severance payment based on performance by share grant
Grant date	1st : March 1, 2007 2nd: January 1, 2008 3rd : March 15, 2008 4th : April 1, 2008
Number of excutives	46
Number of shares granted (*2)	155,519
Vesting condition	Service condition ; 1~3 years Non-market performance condition (*1)
Share price at the grant date	₩ 56,534~72,884
Severance payment	₩ 6,953,733,254 (The average exercise price ; 44,713)
Expiration	0.916~3 years
The risk-free interest rate	4.8%~5.68%
Volatility	0.092~0.148

(*1) Non-market performance condition is measured by long-term evaluation results based on quantified and non-quntified indices.

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

(b) Share-based payment expense for the years ended December 31, 2008 and 2007 is summarized as follows:

In millions of Won		**2008**	**2007**
Share-based payment expense (recognized)			
(Retirement and severance payment)	₩	9,113	1,370
Remaining expense to be recognized in the future years		1,769	4,109

30. Comprehensive Income

Comprehensive income for the years ended December 31, 2008 and 2007 was as follows:

In millions of Won		2008	2007
Net income	₩	894,290	661,206
Change in fair value of available-for-sale securities, net of tax effect of ₩(7,027) in 2008 and ₩5,245 in 2007		25,637	(13,829)
Increase of unrealized gain on valuation of equity method investments, net of tax effect of ₩(483) in 2008 and ₩285 in 2007		2,790	285
Decrease of unrealized loss on valuation of equity method investments, net of tax effect of nil in 2008 and ₩(10) in 2007		639	256
Comprehensive income	₩	923,356	647,918

31. Change in Accounting Policy

The Company changed its accounting policy with regard to equity method accounted investments in conformity with Statement of Korea Accounting Standard (SKAS) No. 15 *Investment In Associates* as revised February 22, 2008. According to the revised policy, when accounting on equity method accounted investments. The company's consolidated net assets should equal the total net assets of all non-consolidated financial statements.

These changes resulted in a decrease in loss on valuation of equity method investments of ₩13 million, equity method investment securities of ₩12 million and unrealized gain on valuation of equity method investments of ₩2,596 million and an increase in capital surplus of ₩2,532 million and unappropriated retained earnings of ₩52 million, respectively. The Company restated the prior period's financial statements in conformance with these changes in accounting policy.

Financial positions of prior three years after adjusting retroactively for the cumulative effect are summarized as follows:

In millions of Won,
except earning per share in Won

		2007		2006		2005	
Account		**Before**	**After**	**Before**	**After**	**Before**	**After**
Loss on valuation of equity method investments	₩	24,999	24,986	5,882	5,869	3,195	3,182
Net Income		661,193	661,206	649,678	649,691	515,925	515,938
Earnings per share		4,992	4,992	4,608	4,609	3,497	3,497
Equity method investment securities		626,693	626,668	490,885	490,847	421,317	421,266
Capital surplus		464,237	466,769	335,413	336,252	300,043	300,882
Unrealized gain on valuation of equity method investments		2,728	132	750	(153)	1,180	277
Unappropriated (undisposed) retained earnings (deficit)		397,276	397,314	(204,796)	(204,770)	404,737	404,750

32. Derivative Instruments

(a) The Company entered into foreign currency forward and foreign currency option contracts to hedge foreign currency risk of accounts receivable. Details of the contracts as of December 31, 2008 were as follows:

In Won and thousands of US dollars

Derivative Instrument	Contractor	Contract position	Exchange rate	Contract date	Expiration date	Contract amount
Currency option	Korea Exchange Bank	Call Option Sell	₩ 988	March 11, 2008	January 28, 2009~	USD 6,000
		Put Option Buy			March 27, 2009	USD 3,000
	Citibank, N.A.,Seoul	Call Option Sell	₩ 989	March 12, 2008	January 28, 2009~	USD 4,000
		Put Option Buy			February 25, 2009	USD 2,000

(b) Details of gain and loss on valuation of derivative instruments for the years ended December 31, 2008 and 2007 are as follows:

In millions of Won		2008	2007
Currency forward	₩	-	(25)
Currency option		(2,699)	-
	₩	(2,699)	(25)

33. Date of Authorization for Issue

The 2008 financial statements were authorized for issue on January 21, 2009, at the Board of Directors Meeting.

34. Results of Operations for the Last Interim Period

In millions of Won, except earnings per share		2008 4th Quarter	2007 4th Quarter
Sales	₩	724,876	617,249
Operating income		274,563	185,761
Net income for the period		245,349	135,015
Earnings per share		1,903	1,023

35. Early adoption of K-IFRS (International Financing Reporting Standards)

The Company has decided to early-adopt K-IFRS in 2009, which all listed companies are required to prepared their financial statements in accordance with IFRS from 2011.

(a) Planning and applying K-IFRS

The Financial Supervisory Commission announced roadmap for the adoption of K-IFRS in March 2007. After the announcement, the Company has organized a Task Force Team to conduct internal training and analyze the effects of adopting K-IFRS. In October 2008, the Company has appointed an External Advisor to analyze the main differences between IFRS and K-IFRS as the first-phase preparation. In the second-phase preparation, the Company established responses to for the major differences and decided on the Company's accounting policies. Currently, in the third-phase preparation, the Company is in the process of preparing financial statements based on K-IFRS as of January 1, 2008 (transition date) and January 1, 2009 (adoption date), and for the year ended December 31, 2008.

(b) Summary of main difference between K-GAAP and K-IFRS

Subject	K-GAAP	K-IFRS
Revenue recognition for construction contracts	Percentage of completion	Revenue recognition at delivery
Valuation on severance and retirement benefit	Estimated payment amount for employees who served more than one year of employment	Based on the Projected Unit Credit Method, provision for severance and retirement benefit is calculated based on actuarial present value and discount rate
Employee benefit – annual leave and bonus payment	Cost is recognized in the period in which obligation for cash payment is determined	Cost is recognized in the period in which the service is received
Offsetting financial asset and liability	Not specific requirement	Financial asset and liability shall be offset when the entity has a legally enforceable right to offset the recognized amount and intends to settle on a net basis
Eliminating financial assets in respect to consumer credit	Elimination occurs when the amount is received from the Financial Institution	Elimination occurs when the amount is collected from the first-debtor
Accounting for membership rights etc.	Membership rights are recognized as other assets	Membership rights are recognized as intangible assets with unlimited useful life
Change in the scope of subsidiaries	Based on the Act on External Audit of Stock Companies, a stock company whose total value of asset is less than KRW 7 billion as of the end of the immediate preceding business year, shall not be considered a subsidiary	If the Parent Company has dominant influence or control over the subsidiary, the Company is deemed to be a subsidiary regardless of the Company size

35. Early adoption of K-IFRS (International Financing Reporting Standards), Continued

(c) Effects on the Affiliated Companies

Due to the application of K-IFRS, the following changes affect the scope of subsidiaries.

Subsidiaries under K-GAAP	Subsidiaries under K-IFRS
KT&G Corporation	KT&G Corporation
Korea Ginseng Corporation	Korea Ginseng Corporation
Korea Ginseng HK, Ltd.	Korea Ginseng HK, Ltd.
Yungjin Pharm. Ind. Co., Ltd.	Yungjin Pharm. Ind. Co., Ltd.
Tae-a Industry Co., Ltd.	Tae-a Industry Co., Ltd.
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.
	Korea Tabacos do Brasil Ltda.
	KGC Sales Co., Ltd.
	KT&G Pars
	KT&G Rus L.L.C.

(d) Effects on the financial position as of January 1, 2008 (transition date)

In millions of Won	Total assets	Total liabilities	Shareholder's Equity
K-GAAP	3,977,801	835,798	3,142,003
Adjustments:			
Revenue recognition for construction contracts	12,623	19,172	(6,549)
Actuarial valuation on severance and retirement benefit	(2,092)	(17,354)	15,262
Employee benefit – annual leave and bonus payment	3,741	76,809	(73,068)
Offsetting financial asset and liability	164,376	164,376	-
Eliminating financial assets in respect to consumer credit	14,955	14,955	-
Bad debts and impairment losses on financial assets	9,072	-	9,072
Accounts for membership rights and etc	(941)	-	(941)
Conversion from securities under equity method to cost method	(458,896)	-	(458,896)
Effect on income tax	(16,026)	(156,319)	140,293
Total adjustments	(273,188)	101,639	(374,827)
K-IFRS	3,704,613	937,437	2,767,176

35. Early adoption of K-IFRS (International Financing Reporting Standards), Continued

(d) Effects on financial position and result of operation as of and for the year ended December 31, 2008(Adoption date)

In millions of Won	Total assets	Total liabilities	Share-holder's Equity	Net income (loss)
K-GAAP	4,382,573	842,744	3,539,829	894,290
Adjustments:				
Revenue recognition for construction contracts	37,473	67,047	(29,574)	(23,025)
Actuarial valuation on severance and retirement benefit	2,301	9,820	(7,519)	17,021
Employee benefit – annual leave and bonus payment	3,890	78,549	(74,659)	(1,590)
Offsetting financial asset and liability	201,774	201,774	-	-
Eliminating financial assets in respect to consumer credit	13,344	13,344	-	-
Bad debts and losses on financial assets	21,009	-	21,009	11,937
Accounts for membership rights and etc	(1,007)	-	(1,007)	(66)
Changes in the useful life of tangible assets	3,806	-	3,806	3,806
Amortization cost method for financial instruments	31	(9)	40	40
Conversion from securities under equity method to cost	(537,514)	-	(537,514)	(74,705)
Effect on income tax	(9,249)	(154,051)	144,802	(4,732)
Total adjustments	(264,142)	216,474	(480,616)	(71,314)
K-IFRS	4,118,431	1,059,218	3,059,213	822,976

The effects on the Company's financial position and result of operation mentioned above are prepared based on the separate financial statement and result may change.

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, 2008. 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, 2008, 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, 2008 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, 2008. We did not review the Company's IACS subsequent to December 31, 2008. This report has been prepared for Korean regulatory purposes, pursuant to the External Audit Law, and may not be appropriate for other purposes or for other users.

Seoul, Korea
January 23, 2009

Notice to Readers

This report is annexed in relation to the audit of the (non-consolidated) financial statements as of December 31, 2008 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

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

I, as the Internal Accounting Control Officer ("IACO") of KT&G Corporation (the "Company"), have assessed the status of the design and operations of the Company's internal accounting control system ("IACS") for the year ended December 31, 2008.

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

Based on the assessment of the operations of the IACS, the Company's IACS has been effectively designed and is operating as of December 31, 2008, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee.

January 23, 2009

Kim, San Kyum, Internal Accounting Control Officer

Kwak, Young Kyoon, Chief Executive Officer