KT&G CORPORATION

Separate Financial Statements

December 31, 2011 and 2010

(With Independent Auditors' Report Thereon)

Contents

Independent Auditors' Report

Based on a report originally issued in Korean

The Board of Directors and Shareholders
KT&G Corporation:

We have audited the accompanying separate statements of financial position of KT&G Corporation (the "Company") as of December 31, 2011 and 2010, and the related separate statements of comprehensive income, changes in equity and cash flows for the years then ended. Management is responsible for the preparation and fair presentation of these separate financial statements in accordance with Korean International Financial Reporting Standards. Our responsibility is to express an opinion on these separate 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 separate financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the separate 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 the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

In our opinion, the separate financial statements referred to above present fairly, in all material respects, the financial position of KT&G Corporation as of December 31, 2011 and 2010 and its financial performance and its cash flows for the years then ended, in accordance with Korean International Financial Reporting Standards.

The accompanying separate financial statements as of and for the year ended December 31, 2011 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation and, in our opinion, the separate financial statements expressed in Korean won have been translated into dollars on the basis set forth in note 4 to the separate financial statements.

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

As discussed in note 29 to the separate financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩584 million for the effects of smoking. The final outcome of these lawsuits cannot be predicted.

The procedures and practices utilized in the Republic of Korea to audit such separate financial statements may differ from those generally accepted and applied in other countries. Accordingly, this report and the accompanying separate financial statements are for use by those knowledgeable about Korean auditing standards and their application in practice.

KPMG Samjong Accounting Corp.
Seoul, Korea
February 16, 2012

This report is effective as of February 16, 2012, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying separate financial statements and notes thereto. Accordingly, the readers of the audit report should understand that the above audit report has not been updated to reflect the impact of such subsequent events or circumstances, if any.

KT&G CORPORATION
Separate Statements of Financial Position

As of December 31, 2011 and 2010

In millions of won and thousands of U.S. dollars	*Note*	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
Assets				
Property, plant and equipment	*5*	₩ 1,163,361	$ 1,008,724	₩ 1,196,126
Intangible assets	*6*	18,972	16,450	48,564
Investment property	*7*	165,053	143,114	98,143
Investments in associates	*8*	36,725	31,843	2,830
Investments in subsidiaries	*9*	1,054,767	914,565	840,121
Available-for-sale financial assets	*10, 28*	247,018	214,184	313,937
Long-term deposits in MSA Escrow Fund	*11,28,29*	147,290	127,711	132,414
Long-term prepaid expenses		4,084	3,541	4,401
Long-term trade and other receivables	*12,28*	199,031	172,575	84,595
Total non-current assets		3,036,301	2,632,707	2,721,131
Inventories	*13*	904,112	783,935	990,333
Trade and other receivables	*12,27,28*	625,756	542,579	527,827
Prepaid tobacco excise and other taxes		198,222	171,874	177,043
Advance payments		9,358	8,114	5,783
Prepaid expenses		402	348	1,707
Current available-for-sale financial assets	*10,28*	1,044	905	1,000
Cash and cash equivalents	*14,28*	639,097	554,147	828,951
		2,377,991	2,061,902	2,532,644
Assets held for sale	*30*	3,196	2,771	-
Total current assets		2,381,187	2,064,673	2,532,644
Total assets		₩ 5,417,488	$ 4,697,380	₩ 5,253,775

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Financial Position, Continued

As of December 31, 2011 and 2010

In millions of won and thousands of U.S. dollars	*Note*	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
Equity				
Ordinary shares	*1,15*	₩ 954,959	$ 828,023	₩ 954,959
Other capital surplus	*15*	3,582	3,106	3,582
Treasury shares	*16*	(343,522)	(297,860)	(216,827)
Gain on reissuance of treasury shares	*16*	485,922	421,332	482,129
Reserve	*17*	2,678,814	2,322,739	2,184,703
Retained earnings	*18,19*	763,738	662,219	929,140
Total equity	*28*	4,543,493	3,939,559	4,337,686
Liabilities				
Long-term trade and other payables	*21,28*	26,628	23,089	22,902
Long-term advance receipts		12,375	10,729	515
Defined benefit liabilities	*22*	47,640	41,308	28,774
Deferred income tax liabilities	*25*	82,923	71,901	93,310
Total non-current liabilities		169,566	147,027	145,501
Short-term borrowings	*20,28*	6,975	6,048	8,618
Trade and other payables	*21,27,28*	248,976	215,881	238,587
Advance receipts		3,935	3,412	7,712
Income tax payable	*25*	138,846	120,390	190,815
Tobacco excise and other taxes payable		305,697	265,063	324,856
Total current liabilities		704,429	610,794	770,588
Total liabilities		873,995	757,821	916,089
Total equity and liabilities		₩ 5,417,488	$ 4,697,380	₩ 5,253,775

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Comprehensive Income

For the years ended December 31, 2011 and 2010

In millions of won and thousands of U.S. dollars, except earnings per share	*Note*	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
Sales:	*27*			
Manufacture of tobacco		₩ 2,390,076	$ 2,072,380	₩ 2,366,230
Real estate		41,208	35,730	100,521
Exports of leaf tobacco and others		59,547	51,632	33,180
		2,490,831	2,159,742	2,499,931
Cost of sales:	*27*			
Manufacture of tobacco		(911,423)	(790,274)	(925,850)
Real estate		(14,741)	(12,782)	(56,435)
Exports of leaf tobacco and others		(40,790)	(35,368)	(19,900)
		(966,954)	(838,424)	(1,002,185)
Gross profit		1,523,877	1,321,318	1,497,746
Other income	*23*	97,497	84,537	130,197
Selling expenses	*23*	(411,449)	(356,758)	(411,108)
General and administrative expenses	*23*	(214,444)	(185,939)	(220,041)
Employee welfare fund		-	-	(9,465)
Other expense	*23*	(62,232)	(53,960)	(62,313)
Profit from operations		933,249	809,198	925,016
Finance income	*24*	94,067	81,564	296,857
Finance costs	*24*	(4,915)	(4,262)	(1,767)
Net finance income	*24*	89,152	77,302	295,090
Profit before income tax		1,022,401	886,500	1,220,106
Income tax expense	*25*	(246,464)	(213,703)	(288,979)
Profit for the year		₩ 775,937	$ 672,797	₩ 931,127
Other comprehensive income (loss):				
Available-for-sale financial assets, net of tax	*10,24,25*	₩ (49,889)	$ (43,257)	₩ (110,759)
Actuarial losses, net of tax	*22,25*	(14,393)	(12,480)	(4,439)
Other comprehensive loss for the year, net of tax		(64,282)	(55,737)	(115,198)
Total comprehensive income for the year		₩ 711,655	$ 617,060	₩ 815,929
Earnings per share in won and U.S. dollars:				
Basic and diluted	*26*	₩ 6,134	$ 5.32	₩ 7,317

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Changes in Equity

For the year ended December 31, 2011

In millions of won		Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
Balance at January 1, 2011	₩	954,959	3,582	(216,827)	482,129	2,184,703	929,140	4,337,686
Total comprehensive income for the year:								
Profit for the year		-	-	-	-	-	775,937	775,937
Other comprehensive income (loss):								
Available-for-sale financial assets, net of tax		-	-	-	-	(49,889)	-	(49,889)
Actuarial losses, net of tax		-	-	-	-	-	(14,393)	(14,393)
Total other comprehensive loss		-	-	-	-	(49,889)	(14,393)	(64,282)
Total comprehensive income (loss) for the year		-	-	-	-	(49,889)	761,544	711,655
Transactions with owners, recorded directly in equity:								
Dividends		-	-	-	-	-	(382,946)	(382,946)
Reacquisition of treasury shares		-	-	(129,671)	-	-	-	(129,671)
Reissuance of treasury shares		-	-	2,976	3,793	-	-	6,769
Transfer to unconditional reserve		-	-	-	-	544,000	(544,000)	-
Total transactions with owners		-	-	(126,695)	3,793	544,000	(926,946)	(505,848)
Balance at December 31, 2011	₩	954,959	3,582	(343,522)	485,922	2,678,814	763,738	4,543,493

See accompanying notes to the separate financial statements.

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

For the year ended December 31, 2011

In thousands of U.S. dollars		Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
Balance at January 1, 2011	$	828,023	3,106	(188,006)	418,043	1,894,306	805,636	3,761,108
Total comprehensive income for the year:								
Profit for the year		-	-	-	-	-	672,797	672,797
Other comprehensive income (loss):								
Available-for-sale financial assets, net of tax		-	-	-	-	(43,257)	-	(43,257)
Actuarial losses, net of tax		-	-	-	-	-	(12,480)	(12,480)
Total other comprehensive loss		-	-	-	-	(43,257)	(12,480)	(55,737)
Total comprehensive income (loss) for the year		-	-	-	-	(43,257)	660,317	617,060
Transactions with owners, recorded directly in equity:								
Dividends		-	-	-	-	-	(332,044)	(332,044)
Reacquisition of treasury shares		-	-	(112,434)	-	-	-	(112,434)
Reissuance of treasury shares		-	-	2,580	3,289	-	-	5,869
Transfer to unconditional reserve		-	-	-	-	471,690	(471,690)	-
Total transactions with owners		-	-	(109,854)	3,289	471,690	(803,734)	(438,609)
Balance at December 31, 2011	$	828,023	3,106	(297,860)	421,332	2,322,739	662,219	3,939,559

See accompanying notes to the separate financial statements.

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

For the year ended December 31, 2010

In millions of won		Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
Balance at January 1, 2010	₩	954,959	2,632	(226,945)	468,274	2,074,108	579,963	3,852,991
Total comprehensive income for the year:								
Profit for the year		-	-	-	-	-	931,127	931,127
Other comprehensive income (loss):								
Available-for-sale financial assets, net of tax		-	-	-	-	(110,759)	-	(110,759)
Actuarial losses, net of tax		-	-	-	-	-	(4,439)	(4,439)
Total other comprehensive loss		-	-	-	-	(110,759)	(4,439)	(115,198)
Total comprehensive income (loss) for the year		-	-	-	-	(110,759)	926,688	815,929
Transactions with owners, recorded directly in equity:								
Dividends		-	-	-	-	-	(356,157)	(356,157)
Reissuance of treasury shares		-	-	10,118	13,855	-	-	23,973
Transfer from reserve for research and human resource development		-	-	-	-	(15,000)	15,000	-
Transfer from reserve for loss on reissuance of treasury shares		-	-	-	-	(26,646)	26,646	-
Transfer to reserve for research and human resource development		-	-	-	-	60,000	(60,000)	-
Transfer to unconditional reserve		-	-	-	-	203,000	(203,000)	-
Transfer of a business operation		-	950	-	-	-	-	950
Total transactions with owners		-	950	10,118	13,855	221,354	(577,511)	(331,234)
Balance at December 31, 2010	₩	954,959	3,582	(216,827)	482,129	2,184,703	929,140	4,337,686

See accompanying notes to the separate financial statements.

KT&G CORPORATION
Separate Statements of Cash Flows

For the years ended December 31, 2011 and 2010

In millions of won and thousands of U.S. dollars	*Note*	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
Cash flows from operating activities				
Cash generated from operations	*31*	₩ 952,067	$ 825,516	₩ 916,063
Income tax paid		(290,179)	(251,608)	(200,595)
Net cash from operating activities		661,888	573,908	715,468
Cash flows from investing activities				
Interest received		28,130	24,391	17,547
Investment income received from long-term deposits in MSA Escrow Fund		10,582	9,176	1,244
Dividends received		57,116	49,524	32,056
Proceeds from sale of investments in subsidiaries		873	757	-
Proceeds from sale of available-for-sale financial assets		2,570	2,229	265,678
Collection of loans to employees		16,854	14,614	43,437
Collection of loans		354	306	72
Proceeds from sale of property, plant and equipment		31,650	27,443	35,088
Proceeds from sale of intangible assets		24,253	21,029	633
Proceeds from sale of assets held for sale		977	847	100,830
Proceeds from transfer of a business operation		-	-	8,566
Withdrawal of guarantee deposits		29,722	25,771	32,145
Acquisition of investments in associates		(16,595)	(14,389)	-
Acquisition of investments in subsidiaries		(214,813)	(186,260)	(123,225)
Acquisition of available-for-sale financial assets		(22,220)	(19,266)	(39,923)
Increase in loans to employees		-	-	(13,366)
Increase in loans		(82,225)	(71,296)	(7,221)
Payments of guarantee deposits		(15,150)	(13,136)	(13,625)
Payments of long-term deposits in MSA Escrow Fund		(165,737)	(143,706)	(124,478)
Acquisition of property, plant and equipment		(4,133)	(3,584)	(7,787)
Acquisition of intangible assets		(2,136)	(1,852)	-
Acquisition of investment property		(31,390)	(27,217)	(34,181)
Net cash provided by (used in) investing activities		(351,318)	(304,619)	173,490
Cash flows from financing activities				
Interest paid		-	-	(5)
Dividends paid		(382,946)	(332,044)	(356,157)
Decrease in deposits received		(6,340)	(5,497)	(6,605)
Reacquisition of treasury shares		(129,671)	(112,435)	-
Increase in deposits received		10,630	9,218	5,446
Reissuance of treasury shares		7,980	6,919	28,396
Net cash used in financing activities		(500,347)	(433,839)	(328,925)
Net increase (decrease) in cash and cash equivalents		(189,777)	(164,550)	560,033
Cash and cash equivalents at beginning of year		828,951	718,764	268,954
Effect of exchange rate fluctuation on cash held		(77)	(67)	(36)
Cash and cash equivalents at end of year		₩ 639,097	$ 554,147	₩ 828,951

See accompanying notes to the separate financial statements.

1. Organization and Description of Business

KT&G Corporation (the "Company"), which is engaged in manufacturing and selling tobaccos, was established on April 1, 1987 as Korea Monopoly Corporation, a wholly-owned enterprise of the Korean government, pursuant to the Korea Monopoly Corporation Act, in order to secure financing and to promote and develop, through efficient management, the monopoly business of red ginseng and tobacco. On April 1, 1989, the Company changed its name to Korea Tobacco and Ginseng Corporation pursuant to the Korea Tobacco and Ginseng Corporation Act. Also, pursuant to the Act on Management Reform and Privatization of Public Enterprises, proclaimed on August 28, 1997 and enforced on October 1, 1997, the Company was excluded from the application of the Act for the Management of Government Invested Enterprises. Accordingly, the Company became an entity existing and operating under the Commercial Code of Korea. The Korean government sold 28,650,000 shares of the Company to the public during 1999 and the Company listed its shares on the Korea Exchange (formerly, 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, 2011, the Company has four manufacturing plants, including the Shintanjin plant, and 14 local headquarters and 139 branches for the sale of tobacco throughout the country. Also, the Company has the Gimcheon plant for fabrication of leaf tobacco and the Cheonan printing plant for the manufacturing of packaging. The head office of the Company is located in Pyeongchon-dong, Daedeok-gu, Daejeon.

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

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

The ownership of the Company's issued ordinary shares as of December 31, 2011 is held as follows:

In millions of won,
except number of shares and percentage of ownership

Shareholder	Number of shares	Percentage of ownership	Amount
Industrial Bank of Korea	9,510,485	6.93%	47,552
Employee Share Ownership Association	3,285,456	2.39%	16,427
Treasury shares	11,543,697	8.41%	57,719
Others	112,952,859	82.27%	564,764
Retirement of treasury shares	-	-	268,497
	137,292,497	100.00%	954,959

2. Basis of Preparation

(a) Statement of Compliance

The separate financial statements have been prepared in accordance with Korean International Financial Reporting Standards ("K-IFRS"), as prescribed in *the Act on External Audit of Corporations in the Republic of Korea*. K-IFRS is effective from the fiscal year beginning on or after January 1, 2011 and the Company early-adopted K-IFRS from 2009.

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

(b) Basis of Measurement

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

- available-for-sale financial assets measured at fair value
- inventories valued at net realizable value

(c) Use of Estimates and Judgments

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

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

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

- classification of investment property – Note 7.

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

- measurement of defined benefit obligations – Note 22
- provisions and contingencies – Note 29.

3. Significant Accounting Policies

(a) Investments in Subsidiaries and Associates in the Separate Financial Statements

These separate financial statements are prepared and presented in accordance with K-IFRS No. 1027. The Company applied the cost method to investments in subsidiaries and associates in accordance with K-IFRS No. 1027. The carrying amount of investment in Korea Ginseng Corporation under previous Korean Generally Accepted Accounting Principles on the date of transition to K-IFRS is considered to be the deemed cost of investments in subsidiaries on the date of transition. Dividends from a subsidiary or associate are recognized in profit or loss when the right to receive the dividend is established.

(b) Foreign Currencies

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

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

Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements are recognized in profit or loss in the period in which they arise. When gains or losses on non-monetary items are recognized in other comprehensive income, exchange components of those gains or losses are recognized in other comprehensive income. Conversely, when gains or losses on non-monetary items are recognized in profit or loss, exchange components of those gains or losses are recognized in profit or loss.

(c) Property, Plant and Equipment

Property, plant and equipment are measured initially at cost and after initial recognition, are carried at cost less accumulated depreciation and accumulated impairment losses. The cost of property, plant and equipment includes expenditure arising directly from the construction or acquisition of the asset, any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management and the initial estimate of the costs of dismantling and removing the item and restoring the site on which they are located.

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

December 31, 2011 and 2010

3. Significant Accounting Policies, Continued

(c) Property, Plant and Equipment, Continued

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

	Useful lives (years)
Buildings and structures	10 ~ 60
Machinery and vehicles	4 ~ 12
Tools, furniture and fixtures	4

A component that is significant compared to the total cost of property, plant and equipment is depreciated over its separate useful life.

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

(d) Intangible Assets

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

The estimated useful lives were as follows:

	Useful lives (years)
Industrial property rights	10 ~ 20 or indefinite
Facility usage rights	indefinite
Other intangible assets	4

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

3. Significant Accounting Policies, Continued

(e) Investment Property

Property held for the purpose of earning rentals or benefiting from capital appreciation is classified as investment property. Investment property is measured initially at its cost including transaction costs and after initial recognition, is carried at cost less accumulated depreciation and accumulated impairment losses.

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

Investment properties, except for land, are depreciated on a straight-line basis over 10 ~ 60 years, the estimated useful lives. Depreciation methods, useful lives and residual values are reviewed at the end of each reporting period and adjusted if appropriate. The change is accounted for as a change in an accounting estimate.

(f) Inventories

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

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

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

Tobacco leaf inventories which have an operating cycle that exceeds 12 months are classified as current assets, consistent with recognized industry practice. The estimated amounts of inventories in current assets which are not expected to be realized within 12 months are ₩385,459 million and ₩403,082 million, respectively, as of December 31, 2011 and 2010.

3. Significant Accounting Policies, Continued

(g) Non-derivative Financial Assets

The Company classifies a non-derivative financial asset into the following four categories: financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables or available-for-sale financial assets, relating to recognition and measurement of financial assets. The Company recognizes financial assets in the separate statement of financial position when the Company becomes a party to the contractual provisions of the financial asset. The Company derecognizes financial assets from the separate statement of financial position when the contractual rights to the cash flows from the financial asset expire or the Company transfers the contractual rights to receive the cash flows on the financial asset in a transaction in which all the risks and rewards of ownership of the financial asset are substantially transferred. If the Company retains substantially all the risks and rewards of ownership of the transferred financial assets, the Company continues to recognize the transferred financial asset and recognizes financial liabilities for the consideration received.

Non-derivative financial assets comprise investments in equity and debt securities, long-term deposits in MSA Escrow Fund and trade and other receivables. When non-derivative financial assets are recognized initially, the Company measures it at its fair value plus, in the case of financial assets not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset.

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

Held-to-maturity Investments
Non-derivative financial assets with fixed or determinable payments and fixed maturity that the Company has the positive intention and ability to hold to maturity are classified as held-to-maturity investments. After initial recognition, held-to-maturity investments are measured at amortized cost using the effective interest method.

Loans and Receivables
Loans and receivables are trade receivables, loans and other receivables with fixed or determinable payments that are not quoted in an active market. After initial recognition, loans and receivables are measured at amortized cost using the effective interest method except for short-term receivables of which the effect of discounting is immaterial.

Available-for-sale Financial Assets
Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as financial assets at fair value through profit or loss, held-to-maturity investments or loans and receivables. Subsequent to initial recognition, they are measured at fair value and changes therein are recognized directly in other comprehensive income, except for impairment losses and foreign exchange gains and losses on monetary available-for-sale financial assets. Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are measured at cost. When the financial asset is derecognized or impairment losses is recognized, the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit or loss. Dividends on an available-for-sale equity instrument are recognized in profit or loss when the Company's right to receive payment is established.

3. Significant Accounting Policies, Continued

(h) Cash and Cash Equivalents

Cash and cash equivalents comprise cash on hand, demand deposits and short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date. Bank overdrafts are included as a component of cash and cash equivalents for the purpose of the separate statement of cash flows.

(i) Non-derivative Financial Liabilities

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

Non-derivative financial liabilities comprise borrowings and trade and other payables. When non-derivative financial liabilities are recognized initially, the Company measures it at its fair value minus, in the case of financial liabilities not at fair value through profit or loss, transaction costs that are directly attributable to the issue of the financial liability.

Financial Liabilities at Fair Value through Profit or Loss
Financial liabilities are classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition transaction costs are recognized in profit or loss when incurred. Financial liabilities at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss.

Other Financial Liabilities
Other financial liabilities are those non-derivative financial liabilities that are not classified as financial liabilities at fair value through profit or loss. After initial recognition, other financial liabilities are measured at amortized cost using the effective interest method except for short-term liabilities of which the effect of discounting is immaterial.

3. Significant Accounting Policies, Continued

(j) Non-current Assets Held for Sale

The Company classifies a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use, and measures it at the lower of its carrying amount and fair value less costs to sell.

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

The Company recognizes an impairment loss for write-down of the asset (or disposal group) to fair value less costs to sell and a gain for increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognized previously in accordance with K-IFRS No.1036 *Impairment of Assets*.

(k) Revenue Recognition

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

Revenue from sale of goods is measured at the fair value of the consideration received or receivable, net of tobacco excise and other taxes, trade discounts and volume rebates. Revenue from the sale of goods is recognized when the Company has transferred to the buyer the significant risks and rewards of ownership of the goods, the Company retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Company and the costs incurred or to be incurred in respect of the transaction can be measured reliably. Tobacco excise and other taxes deducted from revenue for the years ended December 31, 2011 and 2010 were ₩3,374,958 million and ₩3,363,885 million, respectively.

Revenue from the construction of real estate includes the initial amount agreed in the contract plus any variations in contract work, claims and incentive payments, to the extent that it is probable that they will result in revenue and can be measured reliably. As soon as the outcome of a construction contract can be estimated reliably, contract revenue is recognized in profit or loss in proportion to the stage of completion of the contract. The stage of completions is assessed by reference to surveys of work performed.

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

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

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

3. Significant Accounting Policies, Continued

(l) Impairment of Non-financial Assets

The Company assesses at the end of each reporting period whether there is any indication that an asset may be impaired except for inventories, deferred tax assets, assets arising from employee benefits and non-current assets (or disposal groups) classified as held for sale. If any such indication exists, the Company estimates the recoverable amount of the asset. Intangible assets with indefinite useful lives or intangible assets not yet available for use are tested for impairment annually, irrespective of whether there is any indication that it may be impaired. If there is any indication that an asset may be impaired, the recoverable amount is estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, the Company determines the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

The recoverable amount is measured as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. If the recoverable amount of an asset or cash-generating unit is less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. That reduction is recognized in profit or loss.

(m) Impairment of Financial Assets

The Company assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired, except a financial asset at fair value through profit or loss. A financial asset or group of financial assets is considered to be impaired if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset and that loss event has an impact on the estimated future cash flows of the financial asset. For specific financial assets such as trade receivables, if the Company determines that no objective evidence of impairment exists for an individually assessed financial asset, it collectively assesses them for impairment. The objective evidence that the group of loans and receivables is impaired includes an increased number of delayed payments and an adverse change in national or local economic conditions that correlate with defaults on the assets in the group.

The amount of the impairment loss on financial assets carried at amortized cost is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced either directly or through use of an allowance account. The amount of the loss is recognized in profit or loss. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed. The reversal does not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal is recognized in profit or loss.

The amount of the impairment loss on financial assets carried at cost is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses are not reversed.

3. Significant Accounting Policies, Continued

(m) Impairment of Financial Assets, Continued

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

(n) Income Tax

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

Current tax expense is the amount of income tax payable (recoverable) in respect of the taxable profit (tax loss) for a period. Current tax liabilities (assets) for the current and prior periods are measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates that have been enacted or substantively enacted by the end of the reporting period.

Deferred tax assets and liabilities are recognized for temporary differences which are differences between the carrying amount of an asset or liability in the separate statements of financial position and its tax base, the carryforward of unused tax losses and unused tax credits. Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

The Company recognizes a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries and associates, except to the extent that the Company is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The Company recognizes a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries and associates, to the extent that it is probable that the temporary difference will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilized.

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

3. Significant Accounting Policies, Continued

(o) Dividends

The dividends declared to holders of equity instruments after the reporting period are not recognized as a liability at the end of the reporting period.

(p) Equity Capital

Ordinary shares are classified as equity. Incremental costs directly attributable to the equity transaction are recognized as a deduction from equity, net of any tax effects.

When the Company reacquires its share capital, the amount of the consideration paid is recognized as a deduction from equity and classified as treasury shares. The gain or loss on the purchase, sale, reissuance or cancellation of treasury shares is not recognized in profit or loss but recognized directly in equity.

(q) Provisions, Contingent Assets and Contingent Liabilities

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

The amount recognized as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The risks and uncertainties that inevitably surround many events and circumstances are taken into account in reaching the best estimate of a provision. Where the effect of the time value of money is material, the amount of a provision is the present value of the expenditures expected to be required to settle the obligation.

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

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

3. Significant Accounting Policies, Continued

(r) Employee Benefits

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

The Company recognizes the expected cost of profit-sharing and bonus payments if the Company has a present legal or constructive obligation to make such payments as a result of past events; and a reliable estimate of the obligation can be made.

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

Retirement Benefits: Defined Benefit Plans
The Company classifies retirement benefits plans other than defined contribution plans as defined benefit plans. The defined benefit liabilities are calculated at the present value of the defined benefit obligations less the fair value of the plan assets at the end of the reporting period.

In determining the present value of its defined benefit obligations and the related current service cost, the Company uses the projected unit credit method.

With regard to actuarial gains and losses which arise from application of actuarial assumptions, the Company recognizes all actuarial gains and losses in other comprehensive income. Actuarial gains and losses recognized in other comprehensive income are recognized immediately in retained earnings and are not reclassified to profit or loss in a subsequent period.

Termination benefits
The Company recognizes termination benefits as a liability and an expense when, and only when, the Company is demonstrably committed to terminating the employment of an employee or group of employees before the normal retirement date or providing termination benefits as a result of an offer made in order to encourage voluntary redundancy.

(s) Earnings per Share

The Company presents basic and diluted earnings per share ("EPS") data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss for the year attributable to owners of the Company by the weighted-average number of shares outstanding during the period.

Diluted EPS is determined by adjusting the profit or loss for the year attributable to owners of the Company and the weighted-average number of shares outstanding for the effects of all dilutive potential shares, which comprise employee share options.

3. Significant Accounting Policies, Continued

(t) Operating Segments

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

(u) New Standards and Interpretations Not Yet Adopted

The following new standards, interpretations and amendments to existing standards have been published and are mandatory for the Company for annual periods beginning after January 1, 2011, and the Company has not early adopted them. Management believes the impacts of the amendments on the Company's separate financial statements are insignificant.

(i) Amendments to K-IFRS No. 1107 *Financial Instruments: Disclosures*

The amendments require disclosing the nature of the transferred assets, their carrying amount, and the description of risks and rewards for each class of transferred financial assets that are not derecognized in their entirety. If the Company derecognizes transferred financial assets but still has their specific risks and rewards, the amendments require additional disclosures on their effect of risks. The amendments will be applied prospectively for the Group's annual periods beginning on or after July 1, 2011.

(ii) Amendments to K-IFRS No. 1012 *Income Tax*

Deferred tax assets or deferred tax liabilities on investment properties measured at fair value, unless any contrary evidence exists, will be measured by reflecting the tax effect from selling the investment properties. The amendments will be prospectively applied for the Group's annual periods beginning on or after January 1, 2012.

(iii) Amendments to K-IFRS No. 1019 *Employee Benefits*

The standard requires recognition of actuarial gains and losses immediately in other comprehensive income and to calculate expected return on plan assets based on the rate used to discount the defined benefit obligation. The standard will be applied retrospectively for the Company's annual periods beginning on or after January 1, 2013.

(iv) K-IFRS No. 1113 *Fair Value Measurement*

The standard defines fair value and a single framework for fair value, and requires disclosures about fair value measurements. The standard will be applied prospectively for the Company's annual periods beginning on or after January 1, 2013.

December 31, 2011 and 2010

4. Basis of Translating Financial Statements

The separate financial statements are expressed in Korean won and have been translated into U.S. dollars at the rate of ₩1,153.30 to $1, the basic exchange rate on December 31, 2011 posted by Seoul Money Brokerage Services, solely for the convenience of the reader. This translation should not be construed as a representation that any or all of the amounts shown could be converted into U.S. dollars at this or any other rate.

5. Property, Plant and Equipment

(a) Changes in property, plant and equipment for the year ended December 31, 2011 were as follows:

In millions of won		Land, buildings and structures	Machinery and vehicles	Tools, furniture, fixtures and other	Construction-in-progress	Total
Balance at January 1, 2011:						
Cost	₩	1,037,073	828,046	188,894	82,475	2,136,488
Accumulated depreciation and impairment		(252,397)	(547,083)	(140,882)	-	(940,362)
Carrying amount	₩	784,676	280,963	48,012	82,475	1,196,126
Changes:						
Acquisition	₩	43,742	6,144	13,762	102,089	165,737
Disposal		(12,500)	(1,891)	(14)	-	(14,405)
Depreciation		(25,787)	(59,540)	(24,314)	-	(109,641)
Reallocation of construction-in-progress		112,355	29,511	2,614	(144,480)	-
Reclassification from inventories		4,244	-	-	-	4,244
Reclassification from investment property		559	-	-	-	559
Reclassification to investment property		(70,304)	-	-	-	(70,304)
Reclassification to assets held for sale		(8,955)	-	-	-	(8,955)
	₩	43,354	(25,776)	(7,952)	(42,391)	(32,765)
Balance at December 31, 2011:						
Cost	₩	1,098,937	850,502	204,503	40,084	2,194,026
Accumulated depreciation and impairment		(270,907)	(595,315)	(164,443)	-	(1,030,665)
Carrying amount	₩	828,030	255,187	40,060	40,084	1,163,361

5. Property, Plant and Equipment, Continued

(b) Changes in property, plant and equipment for the year ended December 31, 2010 were as follows:

In millions of won		Land, buildings and structures	Machinery and vehicles	Tools, furniture, fixtures and other	Construction-in-progress	Total
Balance at January 1, 2010:						
Cost	₩	1,022,347	835,754	232,769	45,447	2,136,317
Accumulated depreciation and impairment		(229,226)	(523,569)	(173,096)	-	(925,891)
Carrying amount	₩	793,121	312,185	59,673	45,447	1,210,426
Changes:						
Acquisition	₩	4,593	10,500	18,205	91,180	124,478
Disposal		(4,154)	(7,593)	(1,472)	(123)	(13,342)
Depreciation		(25,004)	(60,039)	(29,652)	-	(114,695)
Transfer of sports department		(404)	(60)	(119)	-	(583)
Reallocation of construction-in-progress		16,276	25,970	1,377	(43,623)	-
Reclassification from investment property		248	-	-	-	248
Reclassification to inventories		-	-	-	(9,449)	(9,449)
Reclassification to expenses		-	-	-	(957)	(957)
	₩	(8,445)	(31,222)	(11,661)	37,028	(14,300)
Balance at December 31, 2010:						
Cost	₩	1,037,073	828,046	188,894	82,475	2,136,488
Accumulated depreciation and impairment		(252,397)	(547,083)	(140,882)	-	(940,362)
Carrying amount	₩	784,676	280,963	48,012	82,475	1,196,126

6. Intangible Assets

(a) Changes in intangible assets for the year ended December 31, 2011 were as follows:

In millions of won		Industrial property rights	Facility usage rights	Other intangible assets	Intangible assets under development	Total
Balance at January 1, 2011:						
Cost	₩	6,266	16,514	4,074	31,617	58,471
Accumulated amortization and impairment		(5,187)	-	(4,073)	(647)	(9,907)
Carrying amount	₩	1,079	16,514	1	30,970	48,564
Changes:						
Separate acquisition	₩	-	2,757	-	-	2,757
Internally generated		-	-	-	1,376	1,376
Disposal		-	(3,325)	(1)	-	(3,326)
In-kind capital contribution		-	-	-	(14,454)	(14,454)
Amortization		(31)	-	-	-	(31)
Impairment		-	-	-	(15,914)	(15,914)
Reallocation of intangible assets under development		275	-	-	(275)	-
	₩	244	(568)	(1)	(29,267)	(29,592)
Balance at December 31, 2011:						
Cost	₩	6,541	15,946	4,073	18,264	44,824
Accumulated amortization and impairment		(5,218)	-	(4,073)	(16,561)	(25,852)
Carrying amount	₩	1,323	15,946	-	1,703	18,972

The Company recognized ₩15,914 million of impairment loss on the intangible asset under development for new medicine. The fair value of the intangible asset is measured using the multi-period-excess-earnings method and relief-from-royalty method, as determined by an independent external valuation.

As discussed in note 27 to the separate financial statements, the Company contributed ₩14,454 million of intangible assets under development to Mazence, Inc. as in-kind capital contribution, resulting in ₩6,045 million of gain on sale of intangible assets for the year ended December 31, 2011.

6. Intangible Assets, Continued

(b) Changes in intangible assets for the year ended December 31, 2010 were as follows:

In millions of won		Industrial property rights	Facility usage rights	Other intangible assets	Intangible assets under development	Total
Balance at January 1, 2010:						
Cost	₩	6,175	15,316	658	29,419	51,568
Accumulated amortization and impairment		(5,233)	-	(647)	(647)	(6,527)
Carrying amount	₩	942	15,316	11	28,772	45,041
Changes:						
Separate acquisition	₩	3	1,711	3,416	-	5,130
Internally generated		-	-	-	2,657	2,657
Disposal		(106)	(513)	-	(171)	(790)
Amortization		(48)	-	(11)	-	(59)
Impairment		-	-	(3,415)	-	(3,415)
Reallocation of intangible assets under development		288	-	-	(288)	-
	₩	137	1,198	(10)	2,198	3,523
Balance at December 31, 2010:						
Cost	₩	6,266	16,514	4,074	31,617	58,471
Accumulated amortization and impairment		(5,187)	-	(4,073)	(647)	(9,907)
Carrying amount	₩	1,079	16,514	1	30,970	48,564

The Company recognized ₩3,415 million of impairment loss on the intangible assets relating to the acquisition of the sales network in the United States for the year ended December 31, 2010.

(c) Expenditures not capitalized for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Cost of sales	₩	433	252
Selling expenses		718	630
General and administrative expenses		13,296	9,898
	₩	14,447	10,780

December 31, 2011 and 2010

7. Investment Property

(a) Changes in investment property for the year ended December 31, 2011 were as follows:

In millions of won		Land	Buildings	Total
Balance at January 1, 2011:				
Cost	₩	13,919	116,660	130,579
Accumulated depreciation and impairment		-	(32,436)	(32,436)
Carrying amount	₩	13,919	84,224	98,143
Changes:				
Subsequent expenditure	₩	-	2,136	2,136
Depreciation		-	(4,971)	(4,971)
Reclassification from property, plant and equipment		9,032	61,272	70,304
Reclassification to property, plant and equipment		(268)	(291)	(559)
	₩	8,764	58,146	66,910
Balance at December 31, 2011:				
Cost	₩	22,683	179,605	202,288
Accumulated depreciation and impairment		-	(37,235)	(37,235)
Carrying amount	₩	22,683	142,370	165,053

(b) Changes in investment property for the year ended December 31, 2010 were as follows:

In millions of won		Land	Buildings	Total
Balance at January 1, 2010:				
Cost	₩	13,919	117,010	130,929
Accumulated depreciation and impairment		-	(29,029)	(29,029)
Carrying amount	₩	13,919	87,981	101,900
Changes:				
Depreciation		-	(3,509)	(3,509)
Reclassification to property, plant and equipment		-	(248)	(248)
	₩	-	(3,757)	(3,757)
Balance at December 31, 2010:				
Cost	₩	13,919	116,660	130,579
Accumulated depreciation and impairment		-	(32,436)	(32,436)
Carrying amount	₩	13,919	84,224	98,143

7. Investment Property, Continued

(c) The amounts recognized in profit or loss from investment property for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Rental income	₩	21,105	17,039
Direct operating expense		(4,971)	(3,509)
	₩	16,134	13,530

(d) The carrying amount and the fair value of investment property as of December 31, 2011 and 2010 were as follows:

		2011		2010	
In millions of won		Fair value	Carrying amount	Fair value	Carrying amount
Land	₩	289,422	22,683	163,121	13,919
Buildings		196,258	142,370	89,550	84,224
	₩	485,680	165,053	252,671	98,143

(e) Investment property pledged as collateral as of December 31, 2011 was as follows:

In millions of won

Asset		Carrying amount	Type		Received amount	Collateralized amount	Leaseholder
Investment property	₩	89,705	Leasehold deposits received	₩	6,576	7,469	Metlife Insurance Korea Co., Ltd. and 27 others

(f) Investment property pledged as collateral as of December 31, 2010 was as follows:

In millions of won

Asset		Carrying amount	Type		Received amount	Collateralized amount	Leaseholder
Investment property	₩	32,722	Leasehold deposits received	₩	2,583	3,429	Korea Life Insurance Co., Ltd. and 18 others

December 31, 2011 and 2010

8. Investments in Associates

Investments in associates as of December 31, 2011 and 2010 are summarized as follows:

In millions of won, except percentage of ownership

Associate	Location	Principal operation	2011 Percentage of ownership	2011 Carrying amount	2010 Percentage of ownership	2010 Carrying amount
Cosmo Tabacco Co., Ltd.	Mongolia	Manufacturing and selling tobacco	40.00%	₩ -	40.00%	₩ -
Lite Pharm Tech, Inc.	Korea	Manufacturing medical supplies	25.34%	1,830	25.34%	1,830
Korean Carbon Finance, Inc.	Korea	Emissions trading	20.00%	1,000	20.00%	1,000
JR CR-REIT IV Co., Ltd.	Korea	Selling and renting real estate	49.02%	13,995	-	-
KVG REIT 1 Co., Ltd.	Korea	Selling and renting real estate	29.67%	7,300	-	-
KOCREF REIT 17 Co., Ltd.	Korea	Selling and renting real estate	22.06%	7,000	-	-
JR REIT V Co., Ltd.	Korea	Selling and renting real estate	34.63%	5,600	-	-
				₩ 36,725		₩ 2,830

The Company reclassified ₩17,300 million of available-for-sale financial assets to investments in associates for the year ended December 31, 2011. The Company acquired additional shares of JR CR-REIT IV Co., Ltd., resulting in an increase of the Company's percentage of ownership from 32.68% to 49.02%.

The Company recognized ₩2,947 million of impairment loss on the investment in Cosmo Tabacco Co., Ltd. in years prior to the previous year.

9. Investments in Subsidiaries

Investments in subsidiaries as of December 31, 2011 and 2010 are summarized as follows:

In millions of won, except percentage of ownership

Subsidiary	Location	Principal operation	2011 Percentage of ownership	2011 Carrying amount	2010 Percentage of ownership	2010 Carrying amount
Korea Ginseng Corporation	Korea	Manufacturing and selling ginseng	100.00%	₩ 559,882	100.00%	₩ 559,882
Yungjin Pharm. Ind. Co., Ltd.	Korea	Manufacturing and selling pharmaceuticals	53.00%	66,355	53.00%	66,355
Tae-a Industry Co., Ltd. (*1)	Korea	Manufacturing tobacco materials	100.00%	15,698	100.00%	14,198
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	Manufacturing and selling tobaccos	99.99%	54,049	99.99%	54,049
Korea Tabacos do Brasil Ltda.	Brazil	Processing leaf tobaccos	99.90%	394	99.90%	394
KT&G Pars	Iran	Manufacturing and selling tobaccos	99.99%	5,733	99.99%	5,733
KT&G Rus L.L.C.	Russia	Manufacturing and selling tobaccos	100.00%	110,297	100.00%	110,297
KGC Life & Gin Co., Ltd. (*2)	Korea	Selling ginseng door-to-door	100.00%	31,500	100.00%	22,500
KT&G Bio Corp.	Korea	Manufacturing and selling pharmaceuticals	100.00%	900	100.00%	900
Global Trading, Inc.	USA	Selling tobaccos	100.00%	4,913	100.00%	4,913
Purpleland Development Co., Ltd. (*3)	Korea	Selling and renting real estate	-	-	100.00%	900
Jilin Hanzheng Ginseng Co., Ltd. (*4)	China	Manufacturing and selling ginseng	100.00%	23,247	-	-
Somang Cosmetics Co., Ltd. (*5)	Korea	Manufacturing and selling cosmetics	60.00%	60,721	-	-
Renzoluc Pte., Ltd. (*6)	Singapore	Manufacturing and selling tobaccos	100.00%	89,756	-	-
Mazence, Inc. (*7)	Korea	Medical chemistry research	59.48%	31,232	-	-
Yebon Nongwon Agriculture Co., Ltd (*8)	Korea	Corporate agriculture	90.00%	90	-	-
				₩ 1,054,767		₩ 840,121

(*1) Tae-a Industry Co., Ltd. increased paid-in capital by way of shareholder allocation in 2011, resulting in an increase of the Company's investments in the investee by ₩1,500 million.

(*2) KGC Life & Gin Co., Ltd. increased paid-in capital by way of shareholder allocation in 2011 resulting in an increase of the Company’s investments in the investee by ₩9,000 million.

(*3) Purpleland Development Co., Ltd. was liquidated in 2011.

(*4) The Company established Jilin Hanzheng Ginseng Co., Ltd. with a capital contribution of ₩13,000 million in 2011. Jilin Hanzheng Ginseng Co., Ltd. increased paid-in capital by way of shareholder allocation in 2011, resulting in an increase of the Company’s investments in the investee by ₩10,247 million.

(*5) The Company obtained control of Somang Cosmetics Co., Ltd. by acquiring a 60.00% share of the investee for ₩60,721 million in 2011.

9. Investments in Subsidiaries, Continued

(*6) The Company obtained control of Renzoluc Pte., Ltd. by acquiring a 100.00% share of the investee for ₩89,756 million in 2011.

(*7) The Company obtained control of Mazence, Inc. by contributing ₩10,000 million of cash and ₩20,499 million of intangible assets to the investee as capital contribution in 2011. Accordingly, ₩733 million of available-for-sale financial assets was reclassified to investments in subsidiaries.

(*8) The Company established Yebon Farm with a capital contribution of ₩90 million, obtaining a 90.00% share of the investee in 2011.

10. Available-for-sale Financial Assets

(a) Changes in available-for-sale financial assets for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of period	₩	314,937	443,800
Acquisitions		22,220	39,923
Net changes in fair value before tax		(65,145)	(141,998)
Reclassification to investments in associates		(17,300)	-
Reclassification to investments in subsidiaries		(733)	-
Impairment		(3,988)	-
Disposals		(1,929)	(26,788)
Balance at end of period	₩	248,062	314,937
Statements of financial position:			
- Current	₩	1,044	1,000
- Non-current		247,018	313,937
	₩	248,062	314,937

The Company recognized ₩3,988 million of impairment loss on the available-for-sale equity instruments of Migami, Inc. for the year ended December 31, 2011.

10. Available-for-sale Financial Assets, Continued

(b) Available-for-sale financial assets as of December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011	2010
Available-for-sale debt instruments:			
- Government and municipal bonds	₩	44	44
- Corporate bonds		2,000	20,300
Total available-for-sale debt instruments		2,044	20,344
Available-for-sale equity instruments:			
Listed			
- YTN Co., Ltd.		23,129	30,839
- Oscotech, Inc.		2,049	1,022
- Shinhan Financial Group Co., Ltd.		159,332	212,042
- Rexahn Pharmaceuticals, Inc.		2,801	8,152
		187,311	252,055
Unlisted			
- Dream Hub PFV Co., Ltd.		12,009	12,732
- Migami, Inc.		-	3,988
- Other unlisted available-for-sale equity instruments		46,698	25,818
		58,707	42,538
Total available-for-sale equity instruments		246,018	294,593
Total available-for-sale financial assets	₩	248,062	314,937

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

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

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

11. Long-term Deposits in MSA Escrow Fund

(a) Long-term deposits in MSA Escrow Fund as of December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011	2010
MMF	₩	147,290	74,167
Treasury note		-	58,247
	₩	147,290	132,414

(b) As discussed in note 29 to the separate financial statements, long-term deposits in MSA Escrow Fund are deposited to the United States government related to the export of tobacco to the United States. The payments of long-term deposits in MSA Escrow Fund for the years ended December 31, 2011 and 2010 are ₩15,150 million and ₩13,625 million, respectively.

(c) Investment income on long-term deposits in MSA Escrow Fund for the years ended December 31, 2011 and 2010 are ₩6,658 million and ₩4,637 million, respectively.

(d) Long-term deposits in MSA Escrow Fund are measured at quoted prices in an active market.

12. Trade and Other Receivables

(a) Trade and other receivables as of December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011 Current	2011 Non-current	2010 Current	2010 Non-current
Loans to employees	₩	13,421	32,339	19,287	42,972
Loans		7,123	108,461	14,942	7,374
Other receivables		60,457	22,281	70,822	-
Guarantee deposits		-	35,950	-	34,249
Accrued income		4,051	-	2,989	-
Trade receivables		540,704	-	419,787	-
	₩	625,756	199,031	527,827	84,595

(b) Trade and other receivables as of December 31, 2011 and 2010 have been reported in the separate statements of financial position net of allowances as follows:

In millions of won		2011 Current	2011 Non-current	2010 Current	2010 Non-current
Gross trade and other receivables	₩	631,121	199,031	533,011	84,595
Allowance:					
- Other receivables		(2,083)	-	(1,917)	-
- Trade receivables		(3,282)	-	(3,267)	-
		(5,365)	-	(5,184)	-
Net trade and other receivables	₩	625,756	199,031	527,827	84,595

(c) Changes in the allowance account for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of period	₩	5,184	5,407
Impairment loss on trade receivables		15	63
Impairment loss on other receivables		166	-
Write-off		-	(286)
Balance at end of period	₩	5,365	5,184

Impairment loss on trade and other receivables is included as part of other expense in the separate statements of comprehensive income.

12. Trade and Other Receivables, Continued

(d) The aging schedule of trade and other receivables which were past due but not impaired as of December 31, 2011 and 2010 is as follows:

In millions of won		2011	2010
Within 1 month	₩	26,792	46,679
Between 1 and 2 months		36,245	64,212
Beyond 2 months		71,184	7,226
	₩	134,221	118,117

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

(e) Details of trade and other receivables that are measured at amortized cost as of December 31, 2011 and 2010 were as follows:

	2011				2010			
In millions of won	Effective interest rate		Current	Non-current	Effective interest rate		Current	Non-current
Loans to employees	3.00~5.68%	₩	13,421	32,339	3.00~5.68%	₩	19,287	42,972
Other receivables	3.79%		7,997	22,281	-		-	-
Guarantee deposits	3.00~5.68%		-	35,950	3.00~5.68%		-	34,249
		₩	21,418	90,570		₩	19,287	77,221

There is no material difference between the carrying amount and their fair value except the above trade and other receivables, due to the short-term duration of the majority of trade and other receivables.

13. Inventories

(a) Inventories as of December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011	2010
Finished goods, net of loss on the write-down of inventories	₩	73,643	70,770
Work-in-progress		15,373	14,401
Raw materials		752,335	843,286
Supplies		23,340	23,400
By-products		6,362	7,467
Buildings under construction		-	381
Sites for lotting-out construction		-	9,449
Goods-in-transit		33,059	21,179
	₩	904,112	990,333

(b) The amount of inventories recognized as an expense for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Cost of sales:			
- Loss on the write-down of inventories	₩	14	82
Other expense:			
- Loss on retirement of inventories		3,765	4,036
	₩	3,779	4,118

14. Cash and Cash Equivalents

Cash and cash equivalents as of December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011	2010
Cash on hand	₩	4,298	4,956
Demand deposits		84,799	53,995
Short-term investment assets		550,000	770,000
	₩	639,097	828,951

Cash equivalents mainly include short-term deposits with an original maturity of three months or less. The carrying amount of cash and cash equivalents approximates their fair value.

15. Share Capital

(a) Details of share capital as of December 31, 2011 and 2010 were as follows:

In won, except number of shares		2011	2010
Number of ordinary shares:			
- Authorized		800,000,000	800,000,000
- Issued		137,292,497	137,292,497
- Outstanding		125,748,800	127,648,800
Par value	₩	5,000	5,000

The Company has, thus far, reacquired and retired 53,699,400 shares of treasury share. Accordingly, as of December 31, 2011, the Company's ordinary share differs from the aggregate par value of issued shares by ₩268,497 million.

(b) Changes in the number of shares for the years ended December 31, 2011 and 2010 were as follows:

	2011			2010		
Number of shares	Ordinary shares	Treasury shares	Total	Ordinary shares	Treasury shares	Total
Beginning of period	137,292,497	(9,643,697)	127,648,800	137,292,497	(10,093,697)	127,198,800
Reacquisition of treasury shares	-	(2,000,000)	(2,000,000)	-	-	-
Reissuance of treasury shares	-	100,000	100,000	-	450,000	450,000
End of period	137,292,497	(11,543,697)	125,748,800	137,292,497	(9,643,697)	127,648,800

(c) Changes in the other capital surplus for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of period	₩	3,582	2,632
Acquisition of KGC Life & Gin Co., Ltd.		-	(3,434)
Transfer of the sports department		-	4,384
Balance at end of period	₩	3,582	3,582

In 2010, the Company acquired all the shares of KGC Life & Gin Co., Ltd. for ₩4,934 million from Korea Ginseng Corporation, which is a subsidiary of the Company. The Company recognized investments in subsidiaries at the carrying amount of ₩1,500 million in the financial statements of Korea Ginseng Corporation. Accordingly, the Company recognized a decrease in other capital surplus amounting to ₩3,434 million.

In 2010, the Company disposed of its sports department for ₩8,565 million to Korea Ginseng Corporation, which is a subsidiary of the Company. The Company recognized the difference of ₩4,384 million between the net disposal proceeds and the carrying amount of the sports department as an increase in other capital surplus.

December 31, 2011 and 2010

16. Treasury Shares

(a) Changes in the treasury shares for the years ended December 31, 2011 and 2010 were as follows:

In millions of won, except number of shares	2011 Number of shares	2011 Carrying amount	2010 Number of shares	2010 Carrying amount
Balance at beginning of period	9,643,697	₩ 216,827	10,093,697	₩ 226,945
Reacquisition of treasury shares	2,000,000	129,671	-	-
Reissuance of treasury shares	(100,000)	(2,976)	(450,000)	(10,118)
Balance at end of period	11,543,697	₩ 343,522	9,643,697	₩ 216,827

(b) Changes in gain on reissuance of treasury shares for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of period	₩	482,129	468,274
Gain on reissuance of treasury shares before tax		5,004	18,278
Less: tax at 24.2%		(1,211)	(4,423)
Gain of reissuance of treasury shares, net of tax		3,793	13,855
Balance at end of period	₩	485,922	482,129

17. Reserves

(a) Details of reserves as of December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Accumulated other comprehensive income (loss):			
Available-for-sale financial assets reserve	₩	(31,855)	18,034
Reserves:			
Legal reserve		602,937	602,937
Voluntary reserve		2,107,732	1,563,732
	₩	2,678,814	2,184,703

(b) Available-for-sale financial assets reserve as of December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011	2010
Available-for-sale financial assets reserve before tax	₩	(42,024)	23,121
Tax effect		10,169	(5,087)
	₩	(31,855)	18,034

(c) Legal Reserve

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

17. Reserves, Continued

(d) Details of voluntary reserve as of December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Reserve for business rationalization	₩	12,851	12,851
Reserve for research and human resource development		60,000	60,000
Reserve for business expansion		698,881	698,881
Unconditional reserve		1,336,000	792,000
	₩	2,107,732	1,563,732

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

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

Reserve for Business Expansion
Reserve for business expansion was a legal reserve under *the 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.

Other Reserves
Reserve for research and human resource development was appropriated in order to utilize certain tax deduction benefits through the early recognition of future expenditures. This reserve is restored to retained earnings in accordance with the relevant tax laws. Such reserves are taken back into taxable income in the year of restoration. Reserves without specific purposes are restored to retained earnings by a resolution at a general meeting of shareholders.

18. Retained Earnings

Changes in retained earnings for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of period	₩	929,140	579,963
Transfer from reserve for research and human resource development		-	15,000
Transfer from reserve for loss on reissuance of treasury shares		-	26,646
Transfer to reserve for research and human resource development		-	(60,000)
Transfer to unconditional reserve		(544,000)	(203,000)
Dividends		(382,946)	(356,157)
Profit for the year		775,937	931,127
Actuarial losses, net of tax		(14,393)	(4,439)
Balance at end of period	₩	763,738	929,140

December 31, 2011 and 2010

19. Statements of Appropriation of Retained Earnings

Statements of appropriation of retained earnings for the years ended December 31, 2011 and 2010 are as follows:

Date of appropriation for 2011: February 24, 2012
Date of appropriation for 2010: March 4, 2011

In millions of won		2011	2010
Unappropriated retained earnings:			
Balance at beginning of year	₩	2,194	2,452
Profit for the year		775,937	931,127
Actuarial losses, net of tax		(14,393)	(4,439)
		763,738	929,140
Transfer from voluntary reserves		-	-
Unappropriated retained earnings available for appropriation		763,738	929,140
Appropriation of retained earnings:			
Dividends (note 32)		(402,396)	(382,946)
Unconditional reserve		(359,000)	(544,000)
		(761,396)	(926,946)
Unappropriated retained earnings to be carried over to subsequent year	₩	2,342	2,194

20. Short-term Borrowings

Short-term borrowings as of December 31, 2011 and 2010 are summarized as follows:

In millions of won	Annual interest rate		2011	2010
Customer credit contracts:				
National Agricultural Cooperative Federation	7.23%	₩	5,468	6,965
Kookmin Bank	3M CD rate+2.50%		1,507	1,653
		₩	6,975	8,618

The Company has entered into a customer credit contract with the National Agricultural Cooperative Federation ("NACF") and Kookmin Bank. The financial institutions pay past-due trade receivables for customers and the Company has provided guarantees to the financial institutions for customers. The amount paid by the financial institutions is recognized as short-term borrowings in the separate statements of financial position.

21. Trade and Other Payables

(a) Trade and other payables as of December 31, 2011 and 2010 are summarized as follows:

		2011		2010	
In millions of won		Current	Non-current	Current	Non-current
Leasehold deposits received	₩	-	26,628	-	22,902
Trade payables		20,588	-	21,669	-
Withholdings		4,206	-	2,725	-
Withholdings taxes		114,247	-	114,727	-
Accrued expenses		92,386	-	86,548	-
Other payables		17,549	-	12,918	-
	₩	248,976	26,628	238,587	22,902

(b) Details of trade and other payables that are measured at amortized cost as of December 31, 2011 and 2010 were as follows:

	2011			2010		
In millions of won	Effective interest rate		Amortized cost	Effective interest rate		Amortized cost
Leasehold deposits received	3.00~5.68%	₩	26,628	3.00~5.68%	₩	22,902

There is no material difference between the carrying amount and their fair value except the above trade and other payables, due to the short-term duration of the majority of trade and other payables.

22. Retirement Benefits Plan

The Company operates both defined benefit and defined contribution plans. According to these plans, the Company pays retirement benefits calculated under the plan's benefit formula at the time employees leave the Company. The defined benefit obligations are calculated annually by independent actuaries using the projected unit credit method.

(a) The components of retirement benefits for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Defined benefit costs:			
Current service costs	₩	22,931	26,895
Interest costs		6,096	6,978
Expected returns on plan assets		(4,473)	(6,434)
Gains on the settlement of the plan		489	286
	₩	25,043	27,725
Defined contribution costs:			
Contributions recognized as expense	₩	1,164	960
	₩	26,207	28,685

The Company recognized contributions payable amounting to ₩83 million as other payables (accrued expenses) in the separate statement of financial position as of December 31, 2010.

The Company recognized termination benefits amounting to ₩2,574 million and ₩47,301 million as an expense for the years ended December 31, 2011 and 2010, respectively. With regard to the termination benefits, the Company recognized other payables (accrued expenses) amounting to ₩1,695 in the separate statement of financial position as of December 31, 2010.

(b) Changes in defined benefit liabilities for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of year	₩	28,774	18,295
Retirement benefits		25,043	27,725
Actuarial losses before tax		18,988	5,692
Payments into plan assets		(20,800)	(10,758)
Transfer of the sports department		-	(451)
Payments, including the amount transferred to the defined contribution plan		(4,316)	(11,258)
Changes in accrued expenses		(49)	(471)
Balance at end of year	₩	47,640	28,774
Statements of financial position:			
- Present value of retirement benefit obligations	₩	168,419	133,114
- Fair value of plan assets		(120,779)	(104,340)
Defined benefit liabilities	₩	47,640	28,774

22. Retirement Benefits Plan, Continued

(c) Changes in defined benefit obligations for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of year	₩	133,114	129,813
Current service costs		22,931	26,895
Interest costs		6,096	6,978
Losses on the settlement of the plan		489	286
Actuarial losses before tax		19,028	5,033
Transfer of the sports department		-	(599)
Payments, including the amount transferred to the defined contribution plan		(13,425)	(33,798)
Changes in accrued expenses		186	(1,494)
Balance at end of year	₩	168,419	133,114

(d) Changes in plan assets for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Balance at beginning of year	₩	104,340	111,518
Expected return on plan assets		4,473	6,434
Actuarial gains (losses) before tax		40	(659)
Payments into plan assets		20,800	10,758
Transfer of the sports department		-	(148)
Payments, including the amount transferred to the defined contribution plan		(9,109)	(22,540)
Changes in accrued expenses		235	(1,023)
Balance at end of year	₩	120,779	104,340

Actual returns on plan assets for the years ended December 31, 2011 and 2010 are ₩4,513 million and ₩5,775 million, respectively.

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

(e) The amount of actuarial losses for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Actuarial losses before tax	₩	(18,988)	(5,692)
Tax effect		4,595	1,253
	₩	(14,393)	(4,439)

22. Retirement Benefits Plan, Continued

(f) The components of plan assets as of December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Cash and cash equivalents	₩	4,732	17,532
Short-term trading financial assets		65,206	58,942
Available-for-sale financial assets		50,841	27,866
	₩	120,779	104,340

As of December 31, 2011 and 2010, short-term trading financial assets include severance insurance of ₩67 million and ₩65 million, respectively, which continues to be covered by the existing retirement benefits plan.

(g) The principal actuarial assumptions as of December 31, 2011 and 2010 were as follows:

In millions of won	2011	2010
Rate of salary increases	5.00%	5.00%
Discount rate	4.10%	4.70%
Expected rate of return on plan assets	4.30%	4.40%

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

(h) Sensitivities in respect of the key assumptions used to measure the defined benefit plan were as follows:

In millions of won		1 percentage point increase	1 percentage point decrease
Rate of salary increases:			
- Increase (decrease) in defined benefit obligations	₩	17,138	(15,069)
- Increase (decrease) in retirement benefits before tax		3,038	(2,654)
Discount rate:			
- Increase (decrease) in defined benefit obligations		(16,026)	18,679
- Increase (decrease) in retirement benefits before tax		(1,433)	1,600
Expected rate of return on plan assets:			
- Increase (decrease) in retirement benefits before tax		(1,017)	1,017

The effect on defined benefit obligations is as of December 31, 2011. The effect on retirement benefits before tax is for the year ended December 31, 2011.

23. Profit from Operations

(a) Employee benefit costs for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Salaries	₩	318,247	272,505
Retirement benefits		26,207	28,685
Termination benefits		2,574	47,301
Employee welfare		35,533	29,405
	₩	382,561	377,896

(b) Depreciation and amortization for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Depreciation	₩	114,612	118,204
Amortization		31	59
	₩	114,643	118,263

(c) Details of other income for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Foreign currency transaction gain	₩	21,365	15,068
Foreign currency translation gain		13,085	44
Gain on sale of property, plant and equipment		45,502	101,522
Gain on sale of intangible assets		6,650	2
Others		10,895	13,561
	₩	97,497	130,197

(d) Details of selling expenses for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Salaries	₩	150,079	125,520
Retirement and termination benefits		13,883	33,133
Employee welfare		18,087	14,895
Travel		3,605	3,771
Communications		1,614	1,698
Utilities		5,074	5,195
Taxes and dues		12,733	13,877
Supplies		1,262	929
Rent		11,582	10,969
Depreciation		23,899	29,161
Repairs and maintenance		5,530	5,336
Vehicles		7,308	6,515
Insurance		212	103
Commissions		28,088	27,019
Freight and custody		27,648	26,283
Conferences		1,434	1,387
Advertising		95,615	100,978
Training		972	2,237
Prizes and rewards		2,106	1,472
Normal research and development		718	630
	₩	411,449	411,108

23. Profit from Operations, Continued

(e) Details of general and administrative expenses for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Salaries	₩	56,737	47,927
Retirement and termination benefits		5,274	15,528
Employee welfare		6,616	4,373
Travel		3,065	2,438
Communications		2,086	2,275
Utilities		2,036	1,642
Taxes and dues		1,152	1,652
Supplies		868	1,212
Rent		1,414	1,193
Depreciation		10,448	10,738
Amortization		31	59
Repairs and maintenance		2,363	1,914
Vehicles		1,534	1,513
Insurance		387	288
Commissions		35,589	33,431
Freight and custody		1,852	1,013
Conferences		1,426	1,414
Advertising		62,873	74,613
Training		4,082	5,799
Prizes and rewards		1,315	1,121
Normal research and development		13,296	9,898
	₩	214,444	220,041

(f) Details of other expenses for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Foreign currency transaction loss	₩	17,695	17,428
Foreign currency translation loss		1,548	5,085
Impairment loss on trade receivables		15	63
Impairment loss on other receivables		166	-
Donations		17,845	29,392
Loss on sale of property, plant and equipment		2,762	2,191
Loss on sale of intangible assets		177	159
Impairment loss on intangible assets		15,914	3,415
Impairment loss on investments in associates		27	-
Others		6,083	4,580
	₩	62,232	62,313

24. Net Finance Costs

(a) Details of net finance costs (income) for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Finance cost:			
- Interest costs	₩	927	553
- Loss on sale of available-for-sale financial assets		-	1,214
- Impairment loss on available-for-sale financial assets		3,988	-
		4,915	1,767
Finance income:			
- Interest income		(30,040)	(20,060)
- Dividend income		(56,726)	(32,056)
- Investment income on long-term deposits in MSA Escrow Fund		(6,658)	(4,637)
- Gain on sale of available-for-sale financial assets		(643)	(240,104)
		(94,067)	(296,857)
Net finance costs (income)	₩	(89,152)	(295,090)

(b) Details of interest costs for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Related financial liabilities:			
- Trade and other payables	₩	927	548
- Others		-	5
	₩	927	553

(c) Details of interest income for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Related financial assets:			
- Deposits	₩	27,904	17,199
- Available-for-sale financial assets		69	361
- Trade and other receivables		2,067	2,500
	₩	30,040	20,060

(d) Details of finance income recognized in other comprehensive income for the years ended December 31, 2011 and 2010 were as follows:

		2011			2010		
In millions of won		Before tax	Tax effect	Net of tax	Before tax	Tax effect	Net of tax
Available-for-sale financial assets:							
Net changes in fair value	₩	(65,145)	15,256	(49,889)	96,892	(21,317)	75,575
Less: reclassified to profit or loss		-	-	-	(238,890)	52,556	(186,334)
	₩	(65,145)	15,256	(49,889)	(141,998)	31,239	(110,759)

December 31, 2011 and 2010

25. Income Tax

(a) The Company was subject to income tax on taxable income at the following normal tax rates.

Taxable income	2010	2011	Tax rate Thereafter
Up to ₩200 million	11.0%	11.0%	11.0%
₩200 million ~ ₩20 billion	24.2%	24.2%	22.0%
Over ₩20 billion	24.2%	24.2%	24.2%

In December 2011, the Korean government changed the corporate income tax rate (including resident tax) for taxable income exceeding ₩20 billion from 22.0% to 24.2% prospectively from 2012.

(b) The components of income tax expense for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Current income tax expense	₩	237,986	291,735
Adjustments recognized in the period for current tax of prior periods		225	(363)
Changes in temporary difference		(10,387)	(29,062)
Total income tax expense		227,824	262,310
Tax expense recognized outside profit or loss		18,640	26,669
Income tax expense	₩	246,464	288,979

25. Income Tax, Continued

(c) Current and deferred tax expense that were recognized outside profit or loss for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Current:			
- Other capital surplus	₩	-	(1,400)
- Gain on reissuance of treasury shares		(1,211)	(4,423)
- Actuarial losses		4,595	1,253
		3,384	(4,570)
Deferred:			
- Net changes in fair value of available-for-sale financial assets		15,256	31,239
Tax expense (benefit) recognized outside profit or loss	₩	18,640	26,669

Income tax related to other capital surplus and gain on reissuance of treasury shares was recognized directly in equity and income tax related to actuarial losses and net changes in fair value of available-for-sale financial assets was recognized in other comprehensive income.

(d) The income tax expense calculated by applying statutory tax rates to the Company's profit before tax for the year differs from the actual tax expense in the separate statements of comprehensive income for the years ended December 31, 2011 and 2010 for the following reasons:

In millions of won except tax rate information		2011	2010
Profit before tax	₩	1,022,401	1,220,106
Normal tax rate		24.2%	24.2%
Expense for income taxes at normal tax rate	₩	247,395	295,239
Adjustment:			
- Tax effects of permanent differences	₩	2,638	2,414
- Non-inclusion of proceeds-dividend earned		(12,327)	(7,394)
- Investment tax credits		(1,752)	(981)
- Deferred tax expense relating to changes in tax rates		8,463	-
- Additional income tax (tax return) for prior period		2,047	(299)
Income tax expense	₩	246,464	288,979
Effective tax rate		24.1%	23.7%

25. Income Tax, Continued

(e) Deferred tax expense (benefit) relating to the origination and reversal of temporary differences for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Deferred tax liabilities at end of year	₩	(82,923)	(93,310)
Deferred tax liabilities at beginning of year		(93,310)	(122,372)
Deferred tax expense (benefit)	₩	(10,387)	(29,062)

(f) 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.

(g) The net deferred tax liabilities are reflected in the separate statements of financial position after offsetting assets and liabilities where there is a legally enforceable right to offset current tax assets and liabilities and where the deferred income taxes relate to the same fiscal authority.

(h) Changes in deferred tax assets and liabilities for the year ended December 31, 2011 were as follows:

In millions of won		Balance at beginning of year	Credited to profit (charged to loss)	Changes in tax rates	Charged to other comprehensive income	Balance at end of year
Available-for-sale financial assets	₩	9,861	878	1,074	-	11,813
Accrued expense		17,863	1,312	1,917	-	21,092
Defined benefit liabilities		179	2,264	244	-	2,687
Depreciation		3,895	(265)	363	-	3,993
Investments in subsidiaries		(95,884)	-	(9,588)	-	(105,472)
Foreign currency translations		1,220	(1,220)	-	-	-
Treasury shares		(8,183)	70	(811)	-	(8,924)
Unrealized gain on valuation of available-for-sale financial assets		(5,087)	-	-	15,256	10,169
Voluntary reserve		(13,200)	-	(1,320)	-	(14,520)
Provision for advanced depreciation		(4,722)	-	(472)	-	(5,194)
Others		748	555	130	-	1,433
	₩	(93,310)	3,594	(8,463)	15,256	(82,923)

25. Income Tax, Continued

(i) Changes in deferred tax assets and liabilities for the year ended December 31, 2010 were as follows:

In millions of won		Balance at beginning of year	Credited to profit (charged to loss)	Charged to other comprehensive income	Balance at end of year
Available-for-sale financial assets	₩	9,449	412	-	9,861
Accrued expense		20,411	(2,548)	-	17,863
Donations in excess of tax limit		89	(89)	-	-
Defined benefit liabilities		(1,894)	2,073	-	179
Depreciation		4,169	(274)	-	3,895
Investments in subsidiaries		(95,884)	-	-	(95,884)
Foreign currency translations		3,841	(2,621)	-	1,220
Treasury shares		(8,565)	382	-	(8,183)
Unrealized gain on valuation of available-for-sale financial assets		(36,326)	-	31,239	(5,087)
Voluntary reserve		(13,200)	-	-	(13,200)
Provision for advanced depreciation		(4,722)	-	-	(4,722)
Others		260	488	-	748
	₩	(122,372)	(2,177)	31,239	(93,310)

(j) The income tax payable and income taxes refund before offsetting as of December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Income tax payable	₩	237,986	291,736
Income tax refund		(99,140)	(100,921)
	₩	138,846	190,815

26. Earnings per Share

Basic and diluted earnings per share for the years ended December 31, 2011 and 2010 were as follows:

In millions of won, except share information		2011	2010
Profit for the year	₩	775,937	931,127
Weighted-average number of ordinary shares outstanding		126,505,112	127,251,814
Basic and diluted earnings per share in won	₩	6,134	7,317

27. Transactions and Balances with Related Companies

(a) Details of parent and subsidiary relationships as of December 31, 2011 and 2010 were as follows:

			Percentage of ownership					
			2011			2010		
Subsidiary	Location	Next most senior parent	Parent	Sub-sidiary	Total	Parent	Sub-sidiary	Total
Korea Ginseng Corporation	Korea	The Company	100.00%	-	100.00%	100.00%	-	100.00%
Yungjin Pharm. Ind. Co., Ltd.	Korea	The Company	53.00%	-	53.00%	53.00%	-	53.00%
Tae-a Industry Co., Ltd. (*1)	Korea	The Company	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	The Company	99.99%	-	99.99%	99.99%	-	99.99%
Korea Tabacos do Brasil Ltda.	Brazil	The Company	99.90%	-	99.90%	99.90%	-	99.90%
KT&G Pars	Iran	The Company	99.99%	-	99.99%	99.99%	-	99.99%
KT&G Rus L.L.C.	Russia	The Company	100.00%	-	100.00%	100.00%	-	100.00%
KGC Life & Gin Co., Ltd. (*2)	Korea	The Company	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Bio Corp.	Korea	The Company	100.00%	-	100.00%	100.00%	-	100.00%
Global Trading, Inc.	USA	The Company	100.00%	-	100.00%	100.00%	-	100.00%
Purpleland Development Co., Ltd. (*3)	Korea	The Company	-	-	-	100.00%	-	100.00%
Jilin Hanzheng Ginseng Co., Ltd. (*4)	China	The Company	100.00%	-	100.00%	-	-	-
Somang Cosmetics Co., Ltd. (*5)	Korea	The Company	60.00%	-	60.00%	-	-	-
Rosee Cosmetics Co., Ltd. (*5)	Korea	Somang Cosmetics Co., Ltd.	-	100.00%	100.00%	-	-	-
Renzoluc Pte., Ltd. (*6)	Singapore	The Company	100.00%	-	100.00%	-	-	-
PT Trisakti Purwosari Makmur (*6)	Indonesia	Renzoluc Pte., Ltd.	-	51.00%	51.00%	-	-	-
PT Sentosa Ababi Purwosari (*6)	Indonesia	PT Trisakti Purwosari Makmur	-	99.24%	99.24%	-	-	-
PT Purindo Ilufa (*6)	Indonesia	PT Trisakti Purwosari Makmur	-	100.00%	100.00%	-	-	-
Mazence, Inc. (*7)	Korea	The Company	59.48%	-	59.48%	-	-	-
Yebon Nongwon Agriculture Co., Ltd (*8)	Korea	The Company	90.00%	-	90.00%	-	-	-
Korea Ginseng HK, Ltd. (*9)	Hong Kong	Korea Ginseng Corporation	-	-	-	-	99.99%	99.99%
Cheong Kwan Jang Taiwan Corporation	Taiwan	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korean Red Ginseng Corp., Inc.	USA	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng (China) Corp.	China	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng Corporation Japan (*10)	Japan	Korea Ginseng Corporation	-	100.00%	100.00%	-	-	-

27. Transactions and Balances with Related Companies, Continued

(*1) Tae-a Industry Co., Ltd. increased paid-in capital by way of shareholder allocation in 2011, resulting in an increase of the Company's investments in the investee by ₩1,500 million.

(*2) KGC Life & Gin Co., Ltd. increased paid-in capital by way of shareholder allocation in 2011 resulting in an increase of the Company’s investments in the investee by ₩9,000 million.

(*3) Purpleland Development Co., Ltd. was liquidated in 2011.

(*4) The Company established Jilin Hanzheng Ginseng Co., Ltd. in 2011.

(*5) The Company obtained control of Somang Cosmetics Co., Ltd. by acquiring a 60.00% share of the investee in 2011.

(*6) The Company obtained control of Renzoluc Pte., Ltd. by acquiring a 100.00% share of the investee in 2011.

(*7) The Company obtained control of Mazence, Inc. by contributing ₩10,000 million of cash and ₩20,499 million of intangible assets to the investee as capital contribution in 2011. Accordingly, ₩733 million of available-for-sale financial assets was reclassified to investments in subsidiaries.

(*8) The Company established Yebon Nongwon Agriculture Co., Ltd. with a capital contribution of ₩90 million, obtaining a 90.00% share of the investee in 2011.

(*9) Korea Ginseng HK, Ltd. was liquidated in 2011.

(*10) Korea Ginseng Corporation, which is a subsidiary of the Company, established Korea Ginseng Corporation Japan in 2011.

27. Transactions and Balances with Related Companies, Continued

(b) Significant transactions which occurred in the normal course of business with related companies for the years ended December 31, 2011 and 2010 are summarized as follows:

In millions of won

Relationship	Related Company		2011	2010
Sales and other income:				
Subsidiary	Korea Ginseng Corporation	₩	4,856	4,670
	Yungjin Pharm. Ind. Co., Ltd.		331	225
	Tae-a Industry Co., Ltd.		11	14
	KGC Life & Gin Co., Ltd.		1,527	22
	Purpleland Development Co., Ltd.		7	4
	KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		6,012	4,176
	KT&G Pars		8,500	2,590
	KT&G Rus L.L.C.		23,420	6,557
	Global Trading, Inc.		33,355	6,545
	Jilin Hanzheng Ginseng Co., Ltd.		44	-
	Somang Cosmetics Co., Ltd.		2	-
		₩	78,065	24,803
Purchases and other expenses:				
Subsidiary	Korea Ginseng Corporation	₩	2,286	1,702
	Yungjin Pharm. Ind. Co., Ltd.		30	-
	Tae-a Industry Co., Ltd.		16,088	13,312
	KGC Life & Gin Co., Ltd.		451	-
	Somang Cosmetics Co., Ltd.		130	-
		₩	18,985	15,014

The Company recognized dividends from Korea Ginseng Corporation amounting to ₩50,000 million and ₩30,000 million as finance income for the years ended December 31, 2011 and 2010, respectively.

(c) Account balances with related companies as of December 31, 2011 and 2010 were as follows:

In millions of won

Relationship	Related Company		2011	2010
Receivables:				
Subsidiary	KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	₩	23,084	17,642
	KT&G Pars		30,499	22,114
	KT&G Rus L.L.C.		41,031	8,159
	Global Trading, Inc.		14,574	11,248
	Renzoluc Pte., Ltd.		64,045	-
	Jilin Hanzheng Ginseng Co., Ltd.		9,084	-
	Somang Cosmetics Co., Ltd.		2	-
		₩	182,319	59,163
Payables:				
Subsidiary	Korea Ginseng Corporation		2,414	2,289
	KGC Life & Gin Co., Ltd.		192	-
		₩	2,606	2,289

27. Transactions and Balances with Related Companies, Continued

(d) Details of guarantees provided for related companies as of December 31, 2011 and 2010 were as follows:

In thousands of euro				2011		2010	
Relationship	Type of guarantee	Guarantee recipient		Limit	Exercise	Limit	Exercise
Subsidiary	Guarantee on foreign currency letter of credit opened	KT&G Rus L.L.C.	€	-	-	2,063	2,063

(e) Details of key management personnel compensation for the years ended December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011	2010
Short-term employee benefits	₩	13,176	11,911
Post-employment benefits		1,169	709
	₩	14,345	12,620

28. Risk Management

(a) Overview

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

- credit risk
- liquidity risk
- currency risk
- interest rate risk
- other market price risk.

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

(b) Risk Management Framework

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

28. Risk Management, Continued

(c) Management of Financial Risks

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

The carrying amount of financial assets is maximum exposure to credit risk. The maximum exposure to credit risk as of December 31, 2011 and 2010 is as follows:

In millions of won		2011	2010
Available-for-sale financial assets	₩	248,062	314,937
Long-term deposits in MSA Escrow Fund		147,290	132,414
Trade and other receivables		824,787	612,422
Cash and cash equivalents		639,097	828,951

Export trade receivables to overseas clients, including Alokozay International Limited are ₩274,969 million and ₩235,636 million, equal to 50.9% and 56.1% of the aggregate trade receivables, respectively, as of December 31, 2011 and 2010. The Company's trade receivables mentioned above were insured against non-payment up to USD 35,100 thousand and USD 38,525 thousand by export guarantee insurance with the Korea Export Insurance Corporation, respectively, as of December 31, 2011 and 2010. The Company has no significant concentration of customer credit risk since trade and other receivables, excluding the above export trade receivables, are widely dispersed amongst a large number of customers.

The Company has made deposits on cash, cash equivalents and long-term deposits in NACF and several financial institutions with high credit ratings, thus the credit risks from these financial institutions are very limited.

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

28. Risk Management, Continued

(c) Management of Financial Risks, Continued

The maturity analysis with a residual contractual maturity of financial liabilities as of December 31, 2011 and 2010 is as follows:

				Residual contractual maturity			
In millions of won		Carrying amount	Contractual cash flow	Within 3 months	Between 3 months and 1 year	Between 1 and 5 years	Beyond 5 years
As of December 31, 2011:							
Derivative financial liabilities	₩	-	-	-	-	-	-
Non-derivative financial liabilities:							
- Trade and other payables		157,151	158,259	58,309	89,361	8,531	2,058
- Short-term borrowings		6,975	6,975	6,975	-	-	-
	₩	164,126	165,234	65,284	89,361	8,531	2,058
As of December 31, 2010:							
Derivative financial liabilities	₩	-	-	-	-	-	-
Non-derivative financial liabilities:							
- Trade and other payables		144,037	144,581	59,584	75,105	9,892	-
- Short-term borrowings		8,618	8,618	8,618	-	-	-
	₩	152,655	153,199	68,202	75,105	9,892	-

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

Currency Risk

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

28. Risk Management, Continued

(c) Management of Financial Risks, Continued

The carrying amounts of monetary assets and liabilities denominated in a currency other than the functional currency as of December 31, 2011 and 2010 were as follows:

		2011				2010	
In millions of won		USD	EUR	RUB	THB	USD	EUR
Assets:							
Cash and cash equivalents	₩	24,198	37	-	-	6,228	1,227
Trade and other receivables		419,781	17,078	10,389	60	277,055	9,883
Long-term deposits in MSA Escrow Fund		147,290	-	-	-	132,414	-
	₩	591,269	17,115	10,389	60	415,697	11,110
Liabilities:							
Trade and other payables	₩	3,194	4,281	-	-	1,448	2,434

As of December 31, 2011 and 2010, the effects of a 10% strengthening or weakening of functional currency against foreign currencies other than functional currency on profit before tax were as follows:

		2011		2010	
In millions of won		10% strengthening	10% weakening	10% strengthening	10% weakening
USD	₩	58,808	(58,808)	41,425	(41,425)
EUR		1,283	(1,283)	868	(868)
RUB		1,039	(1,039)	-	-
THB		6	(6)	-	-
	₩	61,136	(61,136)	42,293	(42,293)

The above sensitivity analysis was applied to monetary assets and liabilities denominated in foreign currencies other than the functional currency at the end of the reporting period.

Interest Rate Risk
The Company has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company's management has monitored the level of interest rates regularly and has maintained the balance of borrowings at variable rates and fixed rates. As of December 31, 2011, there is no significant effect on cash flows or the fair value of financial liabilities from the interest rate fluctuation, considering the amounts of interest bearing liabilities.

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

28. Risk Management, Continued

(c) Management of Financial Risks, Continued

As of December 31, 2011 and 2010, the effects of a 5% fluctuation of the price index of stocks on other comprehensive income were as follows:

In millions of won		2011 5% increase	2011 5% decrease	2010 5% increase	2010 5% decrease
Other comprehensive income before tax	₩	8,464	(8,464)	13,338	(13,338)
Tax effect		(2,048)	2,048	(2,934)	2,934
Other comprehensive income, net of tax	₩	6,416	(6,416)	10,404	(10,404)

(d) Management of Capital Risk

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

As of December 31, 2011 and 2010, the Company defines net debt and equity as follows:

In millions of won		2011	2010
Net debt:			
Debt (borrowings)	₩	6,975	8,618
Less:			
- Cash and cash equivalents		(639,097)	(828,951)
- Current available-for-sale financial assets		(1,044)	(1,000)
		(633,166)	(821,333)
Equity	₩	4,543,493	4,337,686

28. Risk Management, Continued

(e) Fair Value of Financial Instruments

The carrying amount and the fair value of financial instruments as of December 31, 2011 and 2010 are summarized as follows:

In millions of won		2011 Carrying amount	2011 Fair value	2010 Carrying amount	2010 Fair value
Assets:					
Financial assets measured at fair value					
- Available-for-sale financial assets	₩	241,924	241,924	284,849	284,849
- Long-term deposits in MSA Escrow Fund		147,290	147,290	132,414	132,414
	₩	389,214	389,214	417,263	417,263
Other financial assets					
- Available-for-sale financial assets	₩	6,138	-	30,088	-
Financial assets carried at amortized cost					
- Trade and other receivables	₩	824,787	824,787	612,422	612,422
- Cash and cash equivalents		639,097	639,097	828,951	828,951
	₩	1,463,884	1,463,884	1,441,373	1,441,373
	₩	1,859,236	1,853,098	1,888,724	1,858,636
Liabilities:					
Financial liabilities measured at fair value	₩	-	-	-	-
Financial liabilities measured at amortized cost					
- Trade and other payables	₩	(157,151)	(157,151)	(144,037)	(144,037)
- Short-term borrowings		(6,975)	(6,975)	(8,618)	(8,618)
	₩	(164,126)	(164,126)	(152,655)	(152,655)
	₩	(164,126)	(164,126)	(152,655)	(152,655)

December 31, 2011 and 2010

28. Risk Management, Continued

(e) Fair Value of Financial Instruments, Continued

The Fair Value Hierarchy
The Company classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The level of fair value hierarchy is as follows:

• Level Ⅰ	The quoted prices in active markets for identical assets or liabilities
• Level Ⅱ	The inputs that are observable for the asset or liability, either directly or indirectly
• Level Ⅲ	The inputs for the asset or liability that are not based on observable market data

The fair value measurements classified by fair value hierarchy as of December 31, 2011 and 2010 were as follows:

In millions of won		Level Ⅰ	Level Ⅱ	Level Ⅲ	Total
As of December 31, 2011:					
Financial assets					
- Available-for-sale financial assets	₩	187,311	42,604	12,009	241,924
- Long-term deposits in MSA Escrow Fund		147,290	-	-	147,290
	₩	334,601	42,604	12,009	389,214
As of December 31, 2010:					
Financial assets					
- Available-for-sale financial assets	₩	252,054	20,063	12,732	284,849
- Long-term deposits in MSA Escrow Fund		132,414	-	-	132,414
	₩	384,468	20,063	12,732	417,263

29. Contingent Liabilities and Financial Commitments

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

(b) As of December 31, 2011, tobacco lawsuits claiming damages of ₩584 million are filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligations to notify smokers of the potential health hazards of smoking. Additionally, as of December 31, 2011, the Company is involved in six lawsuits as a defendant for alleged damages totalling ₩4,140 million. The amount of the liability the Company may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of December 31, 2011.

(c) As of December 31, 2011, the Company has entered into letter of credit agreements with Korea Exchange Bank and other banks with limits in the aggregate of USD 45,000 thousand.

(d) As of December 31, 2011, the Company's trade receivables from the export of cigarettes are insured against non-payment up to USD 35,100 thousand by an export guarantee insurance with the Korea Export Insurance Corporation.

(e) As of December 31, 2011, the Company has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries up to USD 70,000 thousand by Korea Exchange Bank and others.

(f) As of December 31, 2011, the Company and 28 other companies are guaranteed ₩240,000 million by Seoul Guarantee Insurance Co., Ltd. related to the Yongsan International Commercial Development Project.

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

29. Contingent Liabilities and Financial Commitments, Continued

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

Description	Details
Conditional put option granted to Individual Shareholder	The Company shall be required to purchase Individual Shareholder's shares, in whole or in part, at the agreed price if the following conditions are met: • Somang Cosmetics Co., Ltd. satisfies all the listing requirements. • Notwithstanding the written request of Individual Shareholder, Somang Cosmetics Co., Ltd. is not able to undertake the necessary procedures for listing, due to the Company's objection, within three years after the Company acquired Somang Cosmetics Co., Ltd.
Right of first refusal held by the Company	Individual shareholder shall not be permitted to make any transfer of its shares, in whole or in part, unless Individual Shareholder has offered them first to the Company.
Tag-along right held by Individual Shareholder	In the event that the Company proposes to enter into a transaction or a series of related transactions with a third party purchaser to dispose of 50% or more of its shares, then Individual Shareholder shall elect to participate in such disposition upon the terms and conditions no less favorable than those applicable to the Company.

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

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

30. Non-current Assets Held for Sale

In 2011, the Company entered into a contract to sell the land, buildings and others in Cheongju plant to Cheongju City for the purpose of business rationalization. The Company received ₩977 million out of the total present value of sale proceeds amounting to ₩31,255 million, with the remaining amount of ₩30,278 million scheduled to be recovered annually in instalments.

Also, the Company entered into a contract to sell the land, buildings and others of Jeonbuk headquarters to Inwoo AD Co., Ltd. and other in 2011.

The Company recognized non-current assets held for sale at the lower of its carrying amount and fair value less costs to sell. Changes in non-current assets held for sale for the year ended December 31, 2011 were as follows:

In millions of won		Land	Buildings	Structures	Total
Balance at January 1, 2011:					
Cost	₩	-	-	-	-
Accumulated depreciation		-	-	-	-
Carrying amount	₩	-	-	-	-
Changes:					
Disposal		(3,740)	(1,925)	(94)	(5,759)
Reclassification from property, plant and equipment		6,013	2,801	141	8,955
	₩	2,273	876	47	3,196
Balance at December 31, 2011:					
Cost	₩	2,273	1,429	197	3,899
Accumulated depreciation		-	(553)	(150)	(703)
Carrying amount	₩	2,273	876	47	3,196

31. Cash Flows from Operating Activities

Details of cash generated from operations for the years ended December 31, 2011 and 2010 were as follows:

In millions of won		2011	2010
Profit for the years	₩	775,937	931,127
Adjustments for:			
- Income tax expense		246,464	288,979
- Finance costs		4,915	1,767
- Finance income		(94,067)	(296,857)
- Depreciation		114,612	118,204
- Amortization		31	59
- Retirement and termination benefits		28,781	75,986
- Foreign currency translations loss		1,548	5,085
- Loss on the write-down of inventories		14	82
- Impairment loss on trade receivables		15	63
- Impairment loss on other receivables		166	-
- Loss on sale of property, plant and equipment		2,762	2,191
- Loss on sale of intangible assets		177	159
- Impairment loss on intangible assets		15,914	3,415
- Loss on sale of investments in associates		27	-
- Other expense		3,765	4,994
- Foreign currency translations gain		(13,085)	(44)
- Gain on sale of property, plant and equipment		(45,502)	(101,522)
- Gain on sale of intangible assets		(6,650)	(2)
		1,035,824	1,033,686
Changes in working capital:			
- Trade receivables		(114,839)	(15,019)
- Other receivables		17,820	(17,181)
- Advance payments		(3,575)	4,993
- Prepaid expenses		856	(2,256)
- Prepaid tobacco excise and other taxes		(21,179)	(7,603)
- Inventories		78,197	69,318
- Trade payables		(1,009)	(13,337)
- Other payables		13,540	(27,954)
- Advance receipts		(3,776)	(14,817)
- Tobacco excise and other taxes payable		(19,160)	(25,193)
- Payment of retirement and termination benefits		(30,632)	(68,574)
Cash generated from operations	₩	952,067	916,063

December 31, 2011 and 2010

32. Dividends

Dividends and dividends per share proposed or declared before the separate financial statements were authorized for issue but not recognized as a distribution to owners during the years ended December 31, 2011 and 2010 are as follows:

In millions of won, except share information and dividends per share		2011	2010
Number of shares receivable dividend		125,748,800	127,648,800
Dividends per share in won	₩	3,200	3,000
Total dividends		402,396	382,946

33. Date of Authorization for Issue

The separate financial statements were authorized for issue on January 19, 2012, at the Board of Directors meeting.

Independent Auditors' 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, 2011. The Company's management is responsible for designing and maintaining an effective IACS and for its assessment of the effectiveness of the 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, 2011, 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 the 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 the Report on the Operations of Internal Accounting Control System as of December 31, 2011 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, 2011. We did not review the Company's IACS subsequent to December 31, 2011. This report has been prepared for Korean regulatory purposes, pursuant to the External Audit Law, and may not be appropriate for other purposes or for other users.

Seoul, Korea
February 16, 2012

Notice to Readers

This report is annexed in relation to the audit of the financial statements as of December 31, 2011 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, 2011.

The Company's management including the 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, 2011, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee.

January 19, 2012

Kang, Kyeong Bo,	Internal Accounting Control Officer
Min, Young Jin,	Chief Executive Officer