

# **KT&G Corporation and Subsidiaries**

**Interim Consolidated Financial Statements**

**March 31, 2012**

**KT&G Corporation and Subsidiaries**  
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**March 31, 2012**

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## Report on Review of Interim Financial Statements

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

### ***Reviewed Financial Statements***

We have reviewed the accompanying interim consolidated financial statements of KT&G Corporation and its subsidiaries. These financial statements consist of consolidated statement of financial position of KT&G Corporation and its subsidiaries (collectively the Group) as of March 31, 2012, and the related consolidated statements of comprehensive income, changes in equity and cash flows for the three-month period ended March 31, 2012, and a summary of significant accounting policies and other explanatory notes, expressed in Korean won.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with the International Financial Reporting Standards as adopted by the Republic of Korea ("Korean IFRS") 34, *Interim Financial Reporting*, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to issue a report on these consolidated financial statements based on our review.

We conducted our review in accordance with the quarterly review standards established by the Securities and Futures Commission of the Republic of Korea. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the Republic of Korea and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe the accompanying interim consolidated financial statements do not present fairly, in all material respects, in accordance with the Korean IFRS 34, *Interim Financial Reporting*.

**Other Matters**

The interim consolidated statement of comprehensive income, changes in equity and cash flows for the three-month period ended March 31, 2011, presented herein for comparative purposes, were reviewed by other auditors whose report dated May 13, 2011, expressed that nothing has come to their attention that caused them to believe those statements do not present fairly, in all material respects, the financial performance and cash flows of KT&G Corporation and its subsidiaries for the three-month period ended March 31, 2011, in accordance with Korean IFRS.

The consolidated statement of financial position as of December 31, 2011, and the consolidated statement of comprehensive income and changes in equity and cash flows for the year ended December 31, 2011, were audited by other auditors whose report dated February 16, 2012, expressed an unqualified opinion on those statements in accordance with the Korean IFRS. The consolidated statement of financial position as of December 31, 2011, presented herein for comparative purposes, has no exceptions in all material respects.

The accompanying interim consolidated financial statements as of and for the three-month period ended March 31, 2012, have been translated into US dollars solely for the convenience of the reader and have been translated on the basis set forth in Note 34 to the interim consolidated financial statements.

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

*Samil pricewaterhouseCoopers*

Seoul, Korea

May 14, 2012

This report is effective as of May 14, 2012, the review report date. Certain subsequent events or circumstances, which may occur between the review report date and the time of reading this report, could have a material impact on the accompanying interim consolidated financial statements and notes thereto. Accordingly, the readers of the review report should understand that there is a possibility that the above review report may have to be revised to reflect the impact of such subsequent events or

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

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

|   | Notes    | March 31, 2012<br>Korean won | March 31, 2012<br>U.S. dollars<br>(Note 34) | December 31, 2011<br>Korean won |
|---|----------|------------------------------|---|---------------------------------|
| <b>Assets</b>   |          |                              |   |                                 |
| <b>Non-current assets</b>                                   |          |                              |   |                                 |
| Property, plant and equipment                               | 10, 14   | ₩ 1,575,604                  | \$ 1,384,781                                | ₩ 1,584,346                     |
| Intangible assets   | 11       | 255,111                      | 224,214                                     | 258,618                         |
| Investment property   | 12, 14   | 181,937                      | 159,902                                     | 188,351                         |
| Investments in associates                                   | 5, 15    | 47,689                       | 41,914                                      | 35,330                          |
| Available-for-sale financial assets                         | 6, 7     | 275,431                      | 242,073                                     | 247,359                         |
| Other financial assets                                      | 6, 17    | 453                          | 398   | 1,427                           |
| Long-term deposits in MSA Escrow Fund                       | 6, 9, 32 | 150,768                      | 132,508                                     | 147,290                         |
| Long-term advance payments                                  | 32       | 141,912                      | 124,725                                     | 142,879                         |
| Long-term prepaid expenses                                  |          | 5,875                        | 5,163                                       | 5,776                           |
| Long-term trade and other receivables                       | 6, 8     | 128,651                      | 113,070                                     | 134,115                         |
| Deferred income tax assets                                  | 28       | 16,392                       | 14,407                                      | 15,487                          |
|   |          | <u>2,779,823</u>             | <u>2,443,155</u>                            | <u>2,760,978</u>                |
| <b>Current assets</b>                                       |          |                              |   |                                 |
| Inventories   | 16       | 1,480,610                    | 1,301,292                                   | 1,572,299                       |
| Available-for-sale financial assets                         | 6, 7     | 1,044                        | 918   | 1,044                           |
| Other financial assets                                      | 6, 17    | 147,972                      | 130,051                                     | 11,089                          |
| Prepaid tobacco excise and other taxes                      |          | 222,429                      | 195,490                                     | 201,910                         |
| Trade and other receivables                                 | 6, 8     | 872,468                      | 766,803                                     | 833,310                         |
| Advance payments  | 32       | 119,239                      | 104,798                                     | 64,342                          |
| Prepaid expenses  |          | 21,183                       | 18,617                                      | 20,517                          |
| Cash and cash equivalents                                   | 6, 17    | 852,381                      | 749,149                                     | 807,731                         |
|   |          | <u>3,717,326</u>             | <u>3,267,118</u>                            | <u>3,512,242</u>                |
| <b>Assets held for sale</b>                                 | 5, 13    | <u>13,949</u>                | <u>12,259</u>                               | <u>3,196</u>                    |
| <b>Total assets</b>   |          | <u>₩ 6,511,098</u>           | <u>\$ 5,722,532</u>                         | <u>₩ 6,276,416</u>              |
| <b>Equity</b>   |          |                              |   |                                 |
| Capital stock   | 1, 18    | ₩ 954,959                    | \$ 839,303                                  | ₩ 954,959                       |
| Other capital surplus                                       | 18       | 9,537                        | 8,382                                       | 5,333                           |
| Treasury shares   | 19       | (343,522)                    | (301,918)                                   | (343,522)                       |
| Gain on reissuance of treasury shares                       | 19       | 485,922                      | 427,071                                     | 485,922                         |
| Reserve   | 20       | 3,049,805                    | 2,680,440                                   | 2,663,313                       |
| Retained earnings   | 21       | 451,374                      | 396,708                                     | 1,022,126                       |
| <b>Equity attributable to equity holders of the Company</b> |          | <u>4,608,075</u>             | <u>4,049,986</u>                            | <u>4,788,131</u>                |
| <b>Non-controlling interests</b>                            |          | <u>92,378</u>                | <u>81,190</u>                               | <u>96,947</u>                   |
| <b>Total equity</b>   |          | <u>4,700,453</u>             | <u>4,131,176</u>                            | <u>4,885,078</u>                |
| <b>Liabilities</b>  |          |                              |   |                                 |
| <b>Non-current liabilities</b>                              |          |                              |   |                                 |
| Long-term borrowings  | 6, 23    | 58,798                       | 51,677                                      | 37,847                          |
| Long-term trade and other payables                          | 6, 22    | 27,411                       | 24,091                                      | 26,031                          |
| Long-term advance receipts                                  |          | 19,508                       | 17,146                                      | 14,072                          |
| Defined benefit liability                                   | 24       | 91,712                       | 80,604                                      | 83,082                          |
| Provisions for other liabilities and charges                |          | 3,561                        | 3,130                                       | 3,509                           |
| Deferred income tax liabilities                             | 28       | 251,871                      | 221,366                                     | 227,589                         |
|   |          | <u>452,861</u>               | <u>398,014</u>                              | <u>392,130</u>                  |
| <b>Current liabilities</b>                                  |          |                              |   |                                 |
| Borrowings  | 6, 23    | 79,043                       | 69,470                                      | 82,836                          |
| Current portion of long-term borrowings                     | 6, 23    | 2,092                        | 1,839                                       | 3,126                           |
| Trade and other payables                                    | 6, 22    | 405,738                      | 356,598                                     | 422,734                         |
| Advance receipts  |          | 27,797                       | 24,430                                      | 12,628                          |
| Income taxes payable  | 28       | 230,729                      | 202,786                                     | 164,579                         |
| Tobacco excise and other taxes payable                      |          | 612,385                      | 538,219                                     | 313,305                         |
|   |          | <u>1,357,784</u>             | <u>1,193,342</u>                            | <u>999,208</u>                  |
| <b>Total liabilities</b>                                    |          | <u>1,810,645</u>             | <u>1,591,356</u>                            | <u>1,391,338</u>                |
| <b>Total liabilities and equity</b>                         |          | <u>₩ 6,511,098</u>           | <u>\$ 5,722,532</u>                         | <u>₩ 6,276,416</u>              |

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

The US dollar figures are provided for information purposes only and do not form part of the interim consolidated financial statements. Refer to Note 34.

**KT&G Corporation and Subsidiaries**  
**Interim Consolidated Statements of Comprehensive Income**  
**Three-Month Periods Ended March 31, 2012 and 2011**

| (in millions of Korean won<br>and thousands of U.S. dollars, except per share amounts)                        | Notes | Period Ended March 31 |                                   |                    |
|---|-------|-----------------------|-----------------------------------|--------------------|
|   |       | 2012<br>Korean won    | 2012<br>U.S. dollars<br>(Note 34) | 2011<br>Korean won |
| <b>Sales</b>  |       | ₩ 961,562             | \$ 845,107                        | ₩ 824,445          |
| <b>Cost of sales</b>  | 26    | <u>(430,036)</u>      | <u>(377,954)</u>                  | <u>(346,801)</u>   |
| <b>Gross profit</b>   |       | 531,526               | 467,153                           | 477,644            |
| Other income  | 25    | 16,686                | 14,665                            | 12,142             |
| Selling and administrative expenses   | 25,26 | (265,500)             | (233,345)                         | (217,840)          |
| Other expenses  | 25,26 | <u>(24,594)</u>       | <u>(21,616)</u>                   | <u>(22,551)</u>    |
| <b>Operating income</b>   |       | <u>258,118</u>        | <u>226,857</u>                    | <u>249,395</u>     |
| Finance income  | 27    | 12,772                | 11,225                            | 12,489             |
| Finance expense   | 27    | <u>(3,939)</u>        | <u>(3,462)</u>                    | <u>(4,666)</u>     |
| <b>Net Finance income</b>   |       | <u>8,833</u>          | <u>7,763</u>                      | <u>7,823</u>       |
| Income from jointly controlled entities and associates  | 15    | <u>1,286</u>          | <u>1,131</u>                      | <u>273</u>         |
| Expense from jointly controlled entities and associates   | 15    | <u>(165)</u>          | <u>(145)</u>                      | <u>(136)</u>       |
| Profit before income tax  |       | 268,072               | 235,606                           | 257,355            |
| Income tax expense  | 28    | <u>(81,819)</u>       | <u>(71,909)</u>                   | <u>(74,242)</u>    |
| <b>Profit for the period</b>  |       | <u>₩ 186,254</u>      | <u>\$ 163,696</u>                 | <u>₩ 183,113</u>   |
| <b>Other comprehensive income</b>   |       |                       |                                   |                    |
| Change in value of available-for-sale financial assets  | 7     | ₩ 20,325              | \$ 17,864                         | ₩ (13,659)         |
| Gain(Loss) on currency translation of foreign operations  |       | 7,167                 | 6,299                             | 2,634              |
| Actuarial gain(loss) on defined benefit liability   | 24    | <u>(178)</u>          | <u>(157)</u>                      | <u>(63)</u>        |
| <b>Other comprehensive income (loss) for the period, net of tax</b>   |       | <u>27,314</u>         | <u>24,006</u>                     | <u>(11,088)</u>    |
| <b>Total comprehensive income for the period</b>  |       | <u>₩ 213,568</u>      | <u>\$ 187,702</u>                 | <u>₩ 172,025</u>   |
| <b>Profit for the period attributable to:</b>   |       |                       |                                   |                    |
| Equity holders of the Parent Company  |       | ₩ 190,820             | \$ 167,710                        | ₩ 182,397          |
| Non-controlling interests   |       | <u>(4,566)</u>        | <u>(4,014)</u>                    | <u>716</u>         |
|   |       | <u>₩ 186,254</u>      | <u>\$ 163,696</u>                 | <u>₩ 183,113</u>   |
| <b>Total comprehensive income for the period attributable to:</b>   |       |                       |                                   |                    |
| Equity holders of the Parent Company  |       | ₩ 218,137             | \$ 191,718                        | ₩ 171,314          |
| Non-controlling interests   |       | <u>(4,569)</u>        | <u>(4,016)</u>                    | <u>711</u>         |
|   |       | <u>₩ 213,568</u>      | <u>\$ 187,702</u>                 | <u>₩ 172,025</u>   |
| <b>Earnings per share attributable to the equity holders of the Parent Company during the period (in won)</b> |       |                       |                                   |                    |
| Basic and diluted earnings per share  | 29    | <u>₩ 1,517</u>        | <u>\$ 1.33</u>                    | <u>₩ 1,429</u>     |

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

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**KT&G Corporation and Subsidiaries**  
**Interim Consolidated Statements of Changes in Equity**  
**Three-Month Periods Ended March 31, 2012 and 2011**

| Attributable to equity holders of the Parent Company          |               |                          |                    |  |             |                      |             |                              |                 |
|---|---------------|--------------------------|--------------------|--|-------------|----------------------|-------------|------------------------------|-----------------|
| Notes   | Capital stock | Other<br>Capital Surplus | Treasury<br>shares | Gain on<br>reissuance of<br>treasury<br>shares | Reserve     | Retained<br>Earnings | Total       | Non-controlling<br>Interests | Total<br>Equity |
| <i>(in millions of Korean won)</i>                            |               |                          |                    |  |             |                      |             |                              |                 |
| <b>Balance at January 1, 2011</b>                             | ₩ 954,959     | ₩ 5,333                  | ₩ (216,827)        | ₩ 482,129                                      | ₩ 2,179,227 | ₩ 1,151,358          | ₩ 4,556,179 | ₩ 42,130                     | ₩ 4,598,309     |
| <b>Comprehensive income</b>                                   |               |                          |                    |  |             |                      |             |                              |                 |
| Profit for the period   | -             | -                        | -                  | -  | -           | 182,397              | 182,397     | 716                          | 183,113         |
| Change in value of available-for-sale financial assets        | -             | -                        | -                  | -  | (13,659)    | -                    | (13,659)    | -                            | (13,659)        |
| Gain(Loss) on currency translation of foreign operations      | -             | -                        | -                  | -  | 2,634       | -                    | 2,634       | -                            | 2,634           |
| Actuarial gain(loss) on defined benefit liability             | -             | -                        | -                  | -  | -           | (58)                 | (58)        | (5)                          | (63)            |
| <b>Total comprehensive income (loss)</b>                      | -             | -                        | -                  | -  | (11,025)    | 182,339              | 171,314     | 711                          | 172,025         |
| <b>Transactions with equity holders of the Company</b>        |               |                          |                    |  |             |                      |             |                              |                 |
| Cash dividends  | -             | -                        | -                  | -  | -           | (382,946)            | (382,946)   | -                            | (382,946)       |
| Other reserve   | -             | -                        | -                  | -  | 544,000     | (544,000)            | -           | -                            | -               |
| <b>Total transactions with equity holders of the Company</b>  | -             | -                        | -                  | -  | 544,000     | (926,946)            | (382,946)   | -                            | (382,946)       |
| <b>Balance at March 31, 2011</b>                              | ₩ 954,959     | ₩ 5,333                  | ₩ (216,827)        | ₩ 482,129                                      | ₩ 2,712,202 | ₩ 406,751            | ₩ 4,344,547 | ₩ 42,841                     | ₩ 4,387,388     |
| <b>Balance at January 1, 2012</b>                             | ₩ 954,959     | ₩ 5,333                  | ₩ (343,522)        | ₩ 485,922                                      | ₩ 2,663,313 | ₩ 1,022,126          | ₩ 4,788,131 | ₩ 96,947                     | ₩ 4,885,078     |
| <b>Comprehensive income</b>                                   |               |                          |                    |  |             |                      |             |                              |                 |
| Profit for the period   | -             | -                        | -                  | -  | -           | 190,820              | 190,820     | (4,566)                      | 186,254         |
| Change in value of available-for-sale financial assets        | -             | -                        | -                  | -  | 20,325      | -                    | 20,325      | -                            | 20,325          |
| Gain(Loss) on currency translation of foreign operations      | -             | -                        | -                  | -  | 7,167       | -                    | 7,167       | -                            | 7,167           |
| Actuarial gain(loss) on defined benefit liability             | -             | -                        | -                  | -  | -           | (175)                | (175)       | (3)                          | (178)           |
| <b>Total comprehensive income (loss)</b>                      | -             | -                        | -                  | -  | 27,492      | 190,645              | 218,137     | (4,569)                      | 213,568         |
| <b>Transactions with equity holders of the Parent Company</b> |               |                          |                    |  |             |                      |             |                              |                 |
| Cash dividends  | -             | -                        | -                  | -  | -           | (402,396)            | (402,396)   | -                            | (402,396)       |
| Other reserve   | -             | -                        | -                  | -  | 359,000     | (359,000)            | -           | -                            | -               |
| Convertible bond – equity component                           | -             | 4,204                    | -                  | -  | -           | -                    | 4,204       | -                            | 4,204           |
| <b>Total transactions with equity holders of the Company</b>  | -             | 4,204                    | -                  | -  | 359,000     | (761,396)            | (398,192)   | -                            | (398,192)       |
| <b>Balance at March 31, 2012</b>                              | ₩ 954,959     | ₩ 9,537                  | ₩ (343,522)        | ₩ 485,922                                      | ₩ 3,049,805 | ₩ 451,375            | ₩ 4,608,076 | ₩ 92,378                     | ₩ 4,700,454     |

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



**KT&G Corporation and Subsidiaries**  
**Interim Consolidated Statements of Changes in Equity**  
**Three-Month Periods Ended March 31, 2012**

| Attributable to equity holders of the Parent Company          |               |                          |                    |  |              |                      |              |                              |                 |
|---|---------------|--------------------------|--------------------|--|--------------|----------------------|--------------|------------------------------|-----------------|
| Notes   | Capital stock | Other<br>Capital Surplus | Treasury<br>shares | Gain on<br>reissuance of<br>treasury<br>shares | Reserve      | Retained<br>Earnings | Total        | Non-controlling<br>Interests | Total<br>Equity |
| <b>Balance at January 1, 2012</b>                             | \$ 839,303    | \$ 4,687                 | \$ (301,918)       | \$ 427,071                                     | \$ 2,340,756 | \$ 898,335           | \$ 4,208,234 | \$ 85,206                    | \$ 4,293,440    |
| <b>Comprehensive income</b>                                   |               |                          |                    |  |              |                      |              |                              |                 |
| Profit for the period   | -             | -                        | -                  | -  | -            | 167,710              | 167,710      | (4,014)                      | 163,696         |
| Change in value of available-for-sale financial assets        | -             | -                        | -                  | -  | 17,864       | -                    | 17,864       | -                            | 17,864          |
| Gain(Loss) on currency translation of foreign operations      | -             | -                        | -                  | -  | 6,299        | -                    | 6,299        | -                            | 6,299           |
| Actuarial gain(loss) on defined benefit liability             | -             | -                        | -                  | -  | -            | (154)                | (154)        | (2)                          | (156)           |
| <b>Total comprehensive income (loss)</b>                      | -             | -                        | -                  | -  | 24,163       | 167,556              | 191,719      | (4,016)                      | 187,703         |
| <b>Transactions with equity holders of the Parent Company</b> |               |                          |                    |  |              |                      |              |                              |                 |
| Cash dividends  | -             | -                        | -                  | -  | -            | (353,662)            | (353,662)    | -                            | (353,662)       |
| Other reserve   | -             | -                        | -                  | -  | 315,521      | (315,521)            | -            | -                            | -               |
| Convertible bond – equity component                           | -             | 3,695                    | -                  | -  | -            | -                    | 3,695        | -                            | 3,695           |
| <b>Total transactions with equity holders of the Company</b>  | -             | 3,695                    | -                  | -  | 315,521      | (669,183)            | (349,967)    | -                            | (349,967)       |
| <b>Balance at March 31, 2012</b>                              | \$ 839,303    | \$ 8,382                 | \$ (301,918)       | \$ 427,071                                     | \$ 2,680,440 | \$ 396,708           | \$ 4,049,986 | \$ 81,190                    | \$ 4,131,176    |

The accompanying notes are an integral part of these interim consolidated financial statements.  
The US dollar figures are provided for information purposes only and do not form part of the interim consolidated financial statements. Refer to Note 34.

**KT&G Corporation and Subsidiaries**  
**Interim Consolidated Statements of Cash Flows**  
**Three-Month Periods Ended March 31, 2012 and 2011**

| (in millions of Korean won<br>and thousands of U.S. dollars)             | Notes | Period Ended March 31 |                                   |                    |
|--|-------|-----------------------|-----------------------------------|--------------------|
|  |       | 2012<br>Korean won    | 2012<br>U.S. dollars<br>(Note 34) | 2011<br>Korean won |
| <b>Cash flows from operating activities</b>                              |       |                       |                                   |                    |
| Cash generated from operations   | 31    | ₩ 592,663             | \$ 520,885                        | ₩ 264,043          |
| Income tax paid  |       | (1,164)               | (1,023)                           | (99,520)           |
| <b>Net cash generated from operating activities</b>                      |       | <u>591,499</u>        | <u>519,862</u>                    | <u>164,523</u>     |
| <b>Cash flows from investing activities</b>                              |       |                       |                                   |                    |
| Interest received  |       | 6,915                 | 6,077                             | 7,775              |
| Investment income received from long-term deposits<br>in MSA Escrow Fund |       | 70                    | 62                                | 904                |
| Dividends received   |       | 3,416                 | 3,002                             | 200                |
| Proceeds from sale of property, plant and equipment                      |       | 3,938                 | 3,461                             | 6,687              |
| Proceeds from sale of intangible assets                                  |       | 454                   | 399                               | 3,641              |
| Proceeds from sale of available-for-sale financial assets                |       | 1,080                 | 949                               | -                  |
| Decrease in loans  |       | 5,488                 | 4,823                             | 4,463              |
| Decrease in guarantee deposits   |       | 11,164                | 9,812                             | 21,126             |
| Acquisition of property, plant and equipment                             |       | (32,238)              | (28,334)                          | (53,349)           |
| Acquisition of intangible assets   |       | (646)                 | (567)                             | (819)              |
| Acquisition of investment property                                       |       | -                     | -                                 | (1,221)            |
| Acquisition of jointly controlled entities and associates                |       | (11,500)              | (10,107)                          | (12,600)           |
| Acquisition of available-for-sale financial assets                       |       | (1,500)               | (1,318)                           | -                  |
| Increase in loans  |       | (401)                 | (352)                             | (19)               |
| Increase in guarantee deposits   |       | (8,265)               | (7,264)                           | (24,525)           |
| Increase in long-term deposits in MSA Escrow Fund                        |       | (5,578)               | (4,903)                           | (2,859)            |
| Increase(Decrease) in other financial assets                             |       | (135,909)             | (119,449)                         | 6,610              |
| <b>Net cash used in investing activities</b>                             |       | <u>(163,512)</u>      | <u>(143,709)</u>                  | <u>(43,986)</u>    |
| <b>Cash flows from financing activities</b>                              |       |                       |                                   |                    |
| Interest paid  |       | (5,648)               | (4,964)                           | (678)              |
| Dividends paid   |       | (402,396)             | (353,662)                         | -                  |
| Proceeds from long-term borrowings                                       |       | 26,277                | 23,094                            | -                  |
| Proceeds from short-term borrowings                                      |       | 29,807                | 26,197                            | 5,485              |
| Increase in deposits received  |       | 4,972                 | 4,370                             | 5,363              |
| Repayments of long-term borrowings                                       |       | (1,064)               | (935)                             | (128)              |
| Repayments of short-term borrowings                                      |       | (34,294)              | (30,140)                          | (7,485)            |
| Decrease in deposits received  |       | (1,035)               | (909)                             | (3,592)            |
| <b>Net cash used in financing activities</b>                             |       | <u>(383,381)</u>      | <u>(336,949)</u>                  | <u>(1,035)</u>     |
| <b>Net increase in cash and cash equivalents</b>                         |       | 44,606                | 39,203                            | 119,503            |
| <b>Cash and cash equivalents at the beginning of period</b>              |       | 807,731               | 709,906                           | 981,314            |
| <b>Exchange gains/(losses) on cash and cash equivalents</b>              |       | <u>44</u>             | <u>40</u>                         | <u>(1,632)</u>     |
| <b>Cash and cash equivalents at the end of period</b>                    |       | <u>₩ 852,381</u>      | <u>\$ 749,149</u>                 | <u>₩ 1,099,185</u> |

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

The US dollar figures are provided for information purposes only and do not form part of the interim consolidated financial statements. Refer to Note 34.

# **KT&G Corporation and Subsidiaries**

## **Notes to Interim Consolidated Financial Statements**

### **March 31, 2012 and 2011, and December 31, 2011**

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#### **1. General Information**

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

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

As of March 31, 2012, the Parent 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 Parent 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 Parent Company is located in Pyeongchon-dong, Daedeok-gu, Daejeon.

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

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

**KT&G Corporation and Subsidiaries**  
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The ownership of the Parent Company's issued ordinary shares as of March 31, 2012, is held as follows:

| <b>Shareholders</b>                  | <b>Number of shares</b> | <b>Percentage of ownership</b> |
|--------------------------------------|-------------------------|--------------------------------|
| Industrial Bank of Korea             | 9,510,485               | 6.93%                          |
| Employee share ownership association | 3,105,042               | 2.26%                          |
| Others                               | 113,133,273             | 82.40%                         |
|                                      | <hr/> 125,748,800       | <hr/> 91.59%                   |
| Treasury shares                      | 11,543,697              | 8.41%                          |
|                                      | <hr/> 137,292,497       | <hr/> 100.00%                  |

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

| <b>Subsidiaries</b>                         | <b>Location</b> | <b>Percentage of ownership (%)</b> |
|---|-----------------|------------------------------------|
|   |                 | <hr/> <b>March 31, 2012</b>        |
| Korea Ginseng Corporation                   | Korea           | 100.00                             |
| Yungjin Pharm. Ind. Co., Ltd.               | Korea           | 53.00                              |
| Tae-a industry Co., Ltd.                    | Korea           | 100.00                             |
| KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. | Turkey          | 99.99                              |
| Korea Tabacos do Brasil Ltda.               | Brazil          | 99.90                              |
| KT&G Pars                                   | Iran            | 99.99                              |
| KT&G Rus L.L.C.                             | Russia          | 100.00                             |
| KG Life & Gin Co., Ltd                      | Korea           | 100.00                             |
| KT&G Bio Corp.                              | Korea           | 100.00                             |
| Global Trading, Inc.                        | USA             | 100.00                             |
| Jilin Hanzheng Ginseng Co., Ltd.            | China           | 100.00                             |
| Somang Cosmetics Co., Ltd.                  | Korea           | 60.00                              |
| Renzoluc Pte., Ltd.                         | Singapore       | 100.00                             |
| KT&G Life science                           | Korea           | 59.48                              |
| Yebon Nongwon                               | Korea           | 90.00                              |
| KG Yebon                                    | Korea           | 100.00                             |
| Rosee Cosmetics Co., Ltd.                   | Korea           | 100.00                             |
| PT Trisakti Purwosari Makmur                | Indonesia       | 51.00                              |
| PT Sentosa Ababi Purwosari                  | Indonesia       | 99.24                              |
| PT Purindo Ilufa                            | Indonesia       | 100.00                             |
| Cheong Kwan Jang Taiwan Corporation         | Taiwan          | 100.00                             |
| Korean Red Ginseng Corp., Inc.              | USA             | 100.00                             |
| Korea Ginseng (China) Corp.                 | China           | 100.00                             |
| Korea Ginseng Corporation Japan             | Japan           | 100.00                             |

**KT&G Corporation and Subsidiaries**  
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Summarized financial information of subsidiaries as of March 31, 2012 and for the three-month period ended March 31, 2012 is as follows:

*(In millions of Korean won)*

| <b>Subsidiaries</b>                        | <b>Total assets</b> | <b>Total liabilities</b> | <b>Revenue</b> | <b>Profit or loss</b> | <b>Total comprehensive income</b> |
|--|---------------------|--------------------------|----------------|-----------------------|-----------------------------------|
| Korea Ginseng Corporation                  | ₩ 1,213,653         | ₩ 150,840                | ₩ 250,305      | ₩ 45,379              | ₩ 45,288                          |
| Yungjin Pharm. Ind. Co., Ltd.              | 154,496             | 67,798                   | 27,013         | (3,175)               | (3,181)                           |
| Tae-a industry Co., Ltd.                   | 14,643              | 3,179                    | 4,472          | 293                   | 293                               |
| KT&G Tutun Mamulleri Sanayive Ticaret A.S. | 53,312              | 25,142                   | 1,598          | (86)                  | 1,494                             |
| Korea Tabacos do Brasil Ltda.              | 958                 | 11                       | -              | -                     | -                                 |
| KT&G Pars                                  | 34,181              | 36,092                   | 4,198          | (3,702)               | (4,179)                           |
| KT&G Rus L.L.C.                            | 152,245             | 36,719                   | 7,719          | (816)                 | 7,290                             |
| KG Life & Gin Co., Ltd                     | 23,872              | 10,414                   | 15,214         | (4,862)               | (4,862)                           |
| KT&G Bio Corp.                             | 900                 | -                        | -              | -                     | -                                 |
| Global Trading, Inc.                       | 27,389              | 20,009                   | 37,751         | 144                   | 46                                |
| Jilin Hanzheng Ginseng Co., Ltd.           | 37,752              | 15,467                   | -              | (619)                 | (885)                             |
| Somang Cosmetics Co., Ltd.                 | 91,404              | 71,040                   | 30,009         | (1,050)               | (1,050)                           |
| Renzoluc Pte., Ltd.                        | 81,414              | 64,528                   | -              | 134                   | (94)                              |
| KT&G Life science                          | 42,167              | 14,110                   | 1              | (1,249)               | (1,249)                           |
| Yebon Nongwon                              | 99                  | -                        | -              | (1)                   | (1)                               |
| KG Yebon                                   | 12,946              | 34                       | -              | (19)                  | (19)                              |
| Rosee Cosmetics Co., Ltd.                  | 1,497               | -                        | -              | -                     | -                                 |
| PT Trisakti Purwosari Makmur               | 118,568             | 100,531                  | 26,743         | (1,302)               | (1,554)                           |
| Cheong Kwan Jang Taiwan Corporation        | 22,100              | 20,588                   | 4,586          | (302)                 | (288)                             |
| Korean Red Ginseng Corp., Inc.             | 9,015               | 5,644                    | 1,862          | 79                    | 35                                |
| Korea Ginseng (China) Corp.                | 42,753              | 32,592                   | 13,874         | 333                   | 262                               |
| Korea Ginseng Corporation Japan            | 8,933               | 2,647                    | 829            | (1,807)               | (2,353)                           |

During the three-month period ended March 31, 2012, there has been no change in consolidation scope, except KG Yebon which is included in the consolidation.

## **2. Significant Accounting Policies**

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

### **2.1 Basis of Preparation**

The interim consolidated financial statements for the three-month period ended March 31, 2012, have been prepared in accordance Korean IFRS 1034, 'Interim Financial Reporting'. These interim consolidated financial statements have been prepared in accordance with the Korean IFRS standards and interpretations issued and effective or issued and early adopted at the reporting date. The Korean IFRS standards and interpretations that will be applicable at December 31, 2011,

# KT&G Corporation and Subsidiaries

## Notes to Interim Consolidated Financial Statements

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including those that will be applicable on an optional basis, are not known with certainty at the time of preparing these interim consolidated financial statements.

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

- Amendments to Korean-IFRS1019, *Employ benefits*

According to the amendment, the corridor approach to actuarial gains and losses no longer applies. Accordingly, all actuarial gains and losses are immediately recognized as other comprehensive income. This amendment will be effective for the Group as of January 1, 2013. The Group expects that the application of this amendment would not have material impact on its consolidated financial statements.

- Enactment of Korean-IFRS1113, *Fair value measurement*

Korean-IFRS1113, *Fair value measurement*, aims to improve consistency and reduce complexity by providing a precise definition of fair value and a single source of fair value measurement and disclosure requirements for use across Korean-IFRSs. Korean-IFRS1101 does not extend the use of fair value accounting but provides guidance on how it should be applied where its use is already required or permitted by other standards within Korean-IFRSs. This amendment will be effective for the Group as of January 1, 2013, and the Group expects that it would not have a material impact on the Group.

## 2.2 Consolidation

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

### (a) Subsidiaries

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

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

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

Acquisition-related costs are expensed as incurred.

If the business combination is achieved in stages, the acquisition date fair value of the acquirer's

# **KT&G Corporation and Subsidiaries**

## **Notes to Interim Consolidated Financial Statements**

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previously held equity interest in the acquiree is remeasured to fair value at the acquisition date and the resulting gain or loss is recognized in profit or loss.

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

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

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

#### *(b) Associates*

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

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

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

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

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

#### *(c) Joint ventures*

A joint venture is a contractual arrangement whereby two or more parties (venturers) exercise joint control. As with associates, investments in jointly controlled entities are accounted for using the equity method of accounting and are initially recognized at cost. The Group's investment in jointly

# **KT&G Corporation and Subsidiaries**

## **Notes to Interim Consolidated Financial Statements**

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controlled entities includes goodwill identified on acquisition, net of accumulated impairment loss. The Group does not recognize its share of profits or losses from the joint venture that result from the Group's purchase of assets from the joint venture until it re-sells the assets to an independent party. However, a loss on the transaction is recognized immediately if the loss provides evidence of a reduction in the net realizable value of current assets, or an impairment loss.

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

Transactions with non-controlling interests that do not result in loss of control are accounted for as equity transactions; that is, as transactions with the owners in their capacity as owners. The difference between fair value of any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary is recorded in equity. Gains or losses on disposals to non-controlling interests are also recorded in equity.

## **2.3 Segment Reporting**

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

## **2.4 Foreign Currency Translation**

#### *(a) Functional and presentation currency*

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

#### *(b) Transactions and balances*

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

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

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

Translation differences on non-monetary financial assets and liabilities such as equities held at fair value through profit or loss are recognized in profit or loss as part of the fair value gain or loss. Translation differences on non-monetary financial assets, such as equities classified as available-for-sale, are included in other comprehensive income.



# **KT&G Corporation and Subsidiaries**

## **Notes to Interim Consolidated Financial Statements**

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#### *(c) Translation to presentation currency*

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

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

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

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

## **2.5 Cash and Cash Equivalents**

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

## **2.6 Financial Assets**

### **2.6.1 Classification**

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

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

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

#### *(b) Loans and receivables*

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

#### *(c) Held-to-maturity investments*

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group intends and is able to hold to maturity and are classified as 'other financial assets' in the statements of financial position. If the Group were to sell other than an insignificant amounts of held-to-maturity investments, the whole category would be tainted and reclassified as available-for-sale. Held-to-maturity investments are included in non-

# **KT&G Corporation and Subsidiaries**

## **Notes to Interim Consolidated Financial Statements**

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current assets, except for those with maturities of less than 12 months after the end of the reporting period, which are classified as current assets.

#### *(d) Available-for-sale financial assets*

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

#### **2.6.2 Recognition and Measurement**

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

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

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

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

#### **2.6.3 Offsetting financial instruments**

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

#### **2.6.4 Derecognition**

Financial assets are derecognized when the contractual rights to receive cash flows from the investments have expired or have been transferred and the Group has substantially transferred all risks and rewards of ownership. If the risk and rewards of ownership of transferred assets have not been substantially transferred, the Group reviews the level of control retained over that asset and the extent of its continuing involvement to determine if transfers do not qualify for derecognition.

Collaterals (trade receivables and other) provided in transactions of discount and factoring of trade receivables do not meet the requirements for asset derecognition if risks and rewards do not substantially transfer in the event the debtor defaults. Financial liabilities recognized in relation to these transactions are included as borrowings in the Group's statement of financial position.

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**2.7 Impairment of Financial Assets**

*(a) Assets carried at amortized cost*

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

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

- Significant financial difficulty of the issuer or obligor;
- Delinquency in interest or principal payments for more than three months;
- For economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- It becomes probable that the borrower will enter bankruptcy or other financial reorganization;
- The disappearance of an active market for that financial asset because of financial difficulties; or
- Observable data suggesting that there is a measurable decrease in the estimated future cash flows from a portfolio of financial assets since the initial recognition of those assets, even though the decrease cannot be identified with respect to individual financial assets in the portfolio, such as:
  - (i) adverse changes in the payment status of borrowers in the portfolio;
  - (ii) national or local economic conditions that correlate with defaults on the assets in the portfolio.

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

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

*(b) Assets classified as available-for-sale*

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

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**2.8 Trade Receivables**

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

**2.9 Inventories**

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

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

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

Tobacco leaf inventories which have an operating cycle that exceeds 12 months are classified as current assets, consistent with recognized industry practice. The estimated amounts of inventories in current assets which are not expected to be realized within 12 months are ₩ 357,113 million and ₩ 385,459 million as of March 31, 2012 and December 31, 2011, respectively.

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

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

**2.11 Property, Plant and Equipment**

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

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

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

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

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized within 'other gains and losses, net' in the income statement.

#### **2.12 Borrowing Costs**

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

#### **2.13 Government Grants**

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

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

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

#### **2.14 Intangible Assets**

##### *(a) Goodwill*

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

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

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

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#### *(b) Other intangible assets*

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

The estimated useful lives are as follows:

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

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

#### **2.15 Investment Property**

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

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

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

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

#### **2.16 Impairment of Non-financial Assets**

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

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#### **2.17 Trade Payables**

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

#### **2.18 Borrowings**

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

#### **2.19 Compound Financial Instruments**

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

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

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

#### **2.20 Provisions**

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

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

#### **2.21 Current and Deferred Income Tax**

The tax expense for the period comprises current and deferred tax. Tax is recognized in the income statement, except to the extent that it relates to items recognized in other comprehensive income or directly in equity. In this case, the tax is also recognized in other comprehensive income or directly in equity.

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The current income tax charge is calculated on the basis of the tax laws enacted or substantively enacted at the statement of financial position date in the countries where the Group operate and generate taxable income. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. It establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities. Deferred income tax is recognized, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax assets and liabilities are not recognized if they arise from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates and laws that have been enacted or substantially enacted by the statement of financial position date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

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

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

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

## **2.22 Employee Benefits**

### *(a) Defined benefit liability*

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

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

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



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

#### *(b) Termination benefits*

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

## **2.23 Share Capital**

Ordinary shares and preferred shares that are not mandatorily redeemable are classified as equity.

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

## **2.24 Revenue Recognition**

The Group's revenue categories consist of goods sold, services and other income. Revenue from sale of goods is measured at the fair value of the consideration received or receivable, net of tobacco excise and other taxes, trade discounts and volume rebates. Revenue from the sale of goods is recognized when the Group has transferred to the buyer the significant risks and rewards of ownership of the goods, the Group retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Group and the costs incurred or to be incurred in respect of the transaction can be measured reliably. Tobacco excise and other taxes deducted from revenue for the three-month periods ended March 31, 2012 and 2011, were ₩ 803,947 million and ₩ 738,065 million, respectively.

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

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

Revenue from the use by others of the Group's assets yielding interest, royalties and dividends is

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recognized when it is probable that the economic benefits associated with the transaction will flow to the Group and the amount of the revenue can be measured reliably.

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

#### **2.25 Dividend Distribution**

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

### **3. Critical Accounting Estimates and Judgments**

The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. Estimations and assumptions are continuously evaluated with consideration to factors such as events reasonably predictable in the foreseeable future within the present circumstance according to historical experience. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below.

#### *(a) Estimated impairment of goodwill*

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

#### *(b) Income taxes*

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

#### *(c) Fair value of financial instruments*

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

#### *(d) Provisions*

As described in Note 2.20, the Group recognizes provisions for warranties and repairs and estimated returns as of the reporting date. The amounts are estimated based on historical data.

#### *(e) Defined benefit liability*

The present value of the defined benefit liability depends on a number of factors that are determined on an actuarial basis using a number of assumptions. The assumptions used in determining the net cost (income) for pensions include the discount rate. Any changes in these assumptions will impact the carrying amount of the defined benefit liability. The Company determines the appropriate discount rate at the end of each year. This is the interest rate that is

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used to determine the present value of estimated future cash outflows expected to be required to settle the defined benefit liability. In determining the appropriate discount rate, the Company considers the interest rates of high-quality corporate bonds that are denominated in the currency in which the pension benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. Other key assumptions for defined benefit liability are based in part on current market conditions. Additional information is disclosed in Note 24.

## 4. Financial Risk Management

### 4.1 Financial Risk Factors

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

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

#### (a) Market risk

##### i) Foreign exchange risk

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

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

| (in millions of<br>Korean won) | March 31, 2012   |                 |                 | December 31, 2011 |                 |                 |
|--------------------------------|------------------|-----------------|-----------------|-------------------|-----------------|-----------------|
|                                | USD              | EUR             | JPY             | USD               | EUR             | JPY             |
| <b>Assets</b>                  |                  |                 |                 |                   |                 |                 |
| Cash and cash equivalents      | ₩ 22,236         | ₩ 1,058         | ₩ 3,460         | ₩ 26,121          | ₩ 68            | ₩ 1,471         |
| Trade and other receivables    | 539,775          | 19,365          | 12,827          | 431,592           | 17,078          | 3,560           |
| Long-term deposits             | 150,768          | -               | -               | 147,290           | -               | -               |
|                                | <u>₩ 712,779</u> | <u>₩ 20,423</u> | <u>₩ 16,287</u> | <u>₩ 605,003</u>  | <u>₩ 17,146</u> | <u>₩ 5,031</u>  |
| <b>Liabilities</b>             |                  |                 |                 |                   |                 |                 |
| Trade and other payables       | ₩ 24,078         | ₩ 5,459         | ₩ 4,127         | ₩ 41,997          | ₩ 4,491         | ₩ 54,559        |
| Short-term borrowings          | 1,494            | -               | -               | -                 | -               | -               |
|                                | <u>₩ 25,572</u>  | <u>₩ 5,459</u>  | <u>₩ 4,127</u>  | <u>₩ 41,997</u>   | <u>₩ 4,491</u>  | <u>₩ 54,559</u> |

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

| (in millions of<br>Korean won) | March 31, 2012       |                  | December 31, 2011    |                  |
|--------------------------------|----------------------|------------------|----------------------|------------------|
|                                | 10%<br>strengthening | 10%<br>weakening | 10%<br>strengthening | 10%<br>weakening |
| US dollar                      | ₩ 68,635             | ₩ (68,635)       | ₩ 56,301             | ₩ (56,301)       |

ii) Price risk

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

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

| (in millions of Korean won)           | March 31, 2012 |                | December 31, 2011 |                |
|---------------------------------------|----------------|----------------|-------------------|----------------|
|                                       | 5%<br>increase | 5%<br>decrease | 5%<br>increase    | 5%<br>decrease |
| Other comprehensive income before tax | ₩ 7,907        | ₩ (7,907)      | ₩ 8,464           | ₩ (8,464)      |
| Tax effect                            | (1,740)        | 1,740          | (2,048)           | 2,048          |
| Other comprehensive income after tax  | ₩ 6,167        | ₩ (6,167)      | ₩ 6,416           | ₩ (6,416)      |

iii) Interest rate risk

The Group has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Group's management has monitored the level of interest rates regularly and has maintained the balance of borrowings at variable rates and fixed rates. As of March 31, 2012 and December 31, 2011, the amount of borrowings issued at variable rates is ₩ 52,179 million and ₩ 27,840 million, respectively. There is no significant effect on cash flows or the fair value of financial liabilities from the interest rate fluctuation.

(b) Credit Risk

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

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

| <i>(In millions of Korean won)</i>    | March 31, 2012     | December 31, 2011  |
|---------------------------------------|--------------------|--------------------|
| Available-for-sale financial assets   | ₩ 3,876            | ₩ 2,376            |
| Long-term deposits in MSA Escrow Fund | 150,768            | 147,290            |
| Trade and other receivables           | 1,001,119          | 967,425            |
| Other financial assets                | 148,425            | 12,516             |
| Cash and cash equivalents             | 852,381            | 807,731            |
|                                       | <u>₩ 2,156,569</u> | <u>₩ 1,937,338</u> |

#### *(c) Liquidity Risk*

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

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

| March 31, 2012                          |                 |                       |                 |                             |                       |                |   |
|---|-----------------|-----------------------|-----------------|-----------------------------|-----------------------|----------------|---|
| <i>(in millions of Korean won)</i>      | Carrying amount | Contractual cash flow | Within 3 months | Between 3 months and 1 year | Between 1 and 5 years | Beyond 5 years |   |
| Trade and other payables                | ₩ 283,434       | ₩ 283,434             | ₩ 204,164       | ₩ 47,985                    | ₩ 31,285              | ₩ -            | - |
| Short-term borrowings                   | 79,043          | 81,317                | 56,906          | 24,411                      | -                     | -              | - |
| Long-term borrowings                    | 58,798          | 61,678                | 30              | 70                          | 61,206                | 372            | - |
| Current portion of long-term borrowings | 2,092           | 2,249                 | 170             | 2,079                       | -                     | -              | - |

  

| December 31, 2011                       |                 |                       |                 |                             |                       |                |   |
|---|-----------------|-----------------------|-----------------|-----------------------------|-----------------------|----------------|---|
| <i>(in millions of Korean won)</i>      | Carrying amount | Contractual cash flow | Within 3 months | Between 3 months and 1 year | Between 1 and 5 years | Beyond 5 years |   |
| Trade and other payables                | ₩ 311,421       | ₩ 312,555             | ₩ 95,050        | ₩ 208,109                   | ₩ 7,338               | ₩ 2,058        | - |
| Short-term borrowings                   | 82,836          | 82,998                | 50,354          | 32,644                      | -                     | -              | - |
| Long-term borrowings                    | 37,847          | 45,568                | 175             | 542                         | 44,550                | 301            | - |
| Current portion of long-term borrowings | 3,126           | 3,166                 | 1,243           | 1,923                       | -                     | -              | - |

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

## 4.2 Capital Management

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

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

| <i>(in millions of Korean won)</i>          | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|---|-----------------------|--------------------------|
| Total borrowings                            | ₩ 139,932             | ₩ 123,809                |
| Less:                                       |                       |                          |
| -Cash and cash equivalents                  | (852,381)             | (807,731)                |
| -Other financial assets                     | (147,972)             | (11,089)                 |
| -Available-for-sale financial assets        | (1,044)               | (1,044)                  |
| Net debt                                    | (861,465)             | (696,055)                |
| Equity attributable to owners of the parent | ₩ 4,700,453           | ₩ 4,885,077              |

#### **4.3 Fair Value Estimation**

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

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

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

| <i>(In millions of Korean won)</i>  | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total</b> |
|-------------------------------------|----------------|----------------|----------------|--------------|
| Assets                              |                |                |                |              |
| Available-for-sale financial assets | ₩ 214,095      | ₩ 42,392       | ₩ 12,009       | ₩ 268,496    |
| Long-term deposits                  | 150,768        | -              | -              | 150,768      |
| Other financial assets              | 148,425        | -              | -              | 148,425      |
| Total assets                        | ₩ 513,288      | ₩ 42,392       | ₩ 12,009       | ₩ 567,689    |

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

| <i>(In millions of Korean won)</i>  | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total</b> |
|-------------------------------------|----------------|----------------|----------------|--------------|
| Assets                              |                |                |                |              |
| Available-for-sale financial assets | ₩ 187,311      | ₩ 42,604       | ₩ 12,009       | ₩ 241,924    |
| Long-term deposits                  | 147,290        | -              | -              | 147,290      |
| Other financial assets              | 12,516         | -              | -              | 12,516       |
| Total assets                        | ₩ 347,117      | ₩ 42,604       | ₩ 12,009       | ₩ 401,730    |

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

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or available for sale.

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

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

Specific valuation techniques used to value financial instruments include:

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

## 5. Operating Segments

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

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

(2) Segment information on revenue and profit from operations for the three-month periods ended March 31, 2012 and 2011, are as follows:

| (in millions of<br>Korean won) | March 31, 2012 |           |             |          |               |             |              |
|--------------------------------|----------------|-----------|-------------|----------|---------------|-------------|--------------|
|                                | Tobacco        | Ginseng   | Real estate | Others   | Segment total | Elimination | Consolidated |
| Total segment sales            | ₩ 643,851      | ₩ 270,187 | ₩ 9,709     | ₩ 85,794 | ₩ 1,009,541   | ₩ (47,979)  | ₩ 961,562    |
| Less: Inter-segment sales      | 13,405         | 19,940    | 1,913       | 12,721   | 47,979        | (47,979)    | -            |
| External sales                 | 630,446        | 250,247   | 7,796       | 73,073   | 961,562       | -           | 961,562      |
| Profit from operations         | 212,144        | 52,511    | 2,730       | (1,731)  | 265,654       | (7,536)     | 258,118      |

  

| (in millions of<br>Korean won) | March 31, 2011 |           |             |          |               |             |              |
|--------------------------------|----------------|-----------|-------------|----------|---------------|-------------|--------------|
|                                | Tobacco        | Ginseng   | Real estate | Others   | Segment total | Elimination | Consolidated |
| Total segment sales            | ₩ 564,029      | ₩ 258,075 | ₩ 6,258     | ₩ 42,062 | ₩ 870,424     | ₩ (45,979)  | ₩ 824,445    |
| Less: Inter-segment sales      | 11,511         | 26,198    | 1,086       | 7,184    | 45,979        | (45,979)    | -            |
| External sales                 | 552,518        | 231,877   | 5,172       | 34,878   | 824,445       | -           | 824,445      |
| Profit from operations         | 184,546        | 64,200    | 650         | 5,673    | 255,069       | (5,673)     | 249,396      |

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

| (in millions of<br>Korean won)  | March 31, 2012 |            |                |          |                  |             | Consolidated       |
|---------------------------------|----------------|------------|----------------|----------|------------------|-------------|--------------------|
|                                 | Tobacco        | Ginseng    | Real<br>estate | Others   | Segment<br>total | Elimination |                    |
| <b>Assets</b>                   |                |            |                |          |                  |             |                    |
| Segment assets                  | ₩3,390,286     | ₩1,128,453 | ₩138,041       | ₩341,420 | ₩4,998,200       | ₩ (114,290) | ₩ 4,883,910        |
| Equity accounted<br>investments | -              | -          | 44,582         | 3,108    | 47,690           | -           | 47,690             |
| Assets held for sale            | 13,949         | -          | -              | 1,497    | 15,446           | (1,497)     | 13,949             |
|                                 | ₩3,404,235     | ₩1,128,453 | ₩182,623       | ₩346,025 | ₩5,061,336       | ₩ (115,787) | 4,945,549          |
| Unallocated assets              |                |            |                |          |                  |             | 1,565,548          |
| <b>Total assets</b>             |                |            |                |          |                  |             | <b>₩ 6,511,097</b> |
| <b>Liabilities</b>              |                |            |                |          |                  |             |                    |
| Segment liabilities             | ₩1,054,971     | ₩ 151,669  | ₩ -            | ₩ 68,655 | ₩1,275,295       | ₩ (114,319) | ₩ 1,160,976        |
| Unallocated<br>liabilities      |                |            |                |          |                  |             | 649,668            |
| <b>Total liabilities</b>        |                |            |                |          |                  |             | <b>₩ 1,810,644</b> |

| (in millions of<br>Korean won)  | March 31, 2012 |            |                |          |                  |             | Consolidated      |
|---------------------------------|----------------|------------|----------------|----------|------------------|-------------|-------------------|
|                                 | Tobacco        | Ginseng    | Real<br>estate | Others   | Segment<br>total | Elimination |                   |
| <b>Assets</b>                   |                |            |                |          |                  |             |                   |
| Segment assets                  | ₩3,332,975     | ₩1,128,405 | ₩154,456       | ₩382,278 | ₩4,998,114       | ₩ (121,801) | ₩4,876,313        |
| Equity accounted<br>investments | -              | -          | 33,681         | 1,649    | 35,330           | -           | 35,330            |
| Assets held for sale            | 3,196          | -          | -              | -        | 3,196            | -           | 3,196             |
|                                 | ₩3,336,171     | ₩1,128,405 | ₩188,137       | ₩383,927 | ₩5,036,640       | ₩ (121,801) | ₩4,914,839        |
| Unallocated assets              |                |            |                |          |                  |             | 1,361,577         |
| <b>Total assets</b>             |                |            |                |          |                  |             | <b>₩6,276,416</b> |
| <b>Liabilities</b>              |                |            |                |          |                  |             |                   |
| Segment liabilities             | ₩ 766,856      | ₩ 136,388  | ₩ -            | ₩ 71,461 | ₩ 974,705        | ₩ (124,565) | ₩850,140          |
| Unallocated<br>liabilities      |                |            |                |          |                  |             | 541,198           |
| <b>Total liabilities</b>        |                |            |                |          |                  |             | <b>₩1,391,338</b> |

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

| Segment | Major customer                 | March 31, 2012 | March 31, 2011 |
|---------|--------------------------------|----------------|----------------|
| Tobacco | Alokozay International Limited | ₩ 92,202       | ₩ 98,783       |



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**6. Financial Instruments by Category**

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

| <b>March 31, 2012</b>                               |                              |  |   |  |                    |
|---|------------------------------|--|---|--|--------------------|
| <i>(in millions of Korean won)</i>                  | <b>Loans and receivables</b> | <b>Assets at fair value through profit or loss</b> | <b>Derivative financial instruments</b> | <b>Assets classified as available-for-sale</b> | <b>Total</b>       |
| Cash and cash equivalents                           | ₩ 852,381                    | ₩ -  | ₩ -                                     | ₩ -  | ₩ 852,381          |
| Financial assets as available-for-sale, current     | -                            | -  | -                                       | 1,044  | 1,044              |
| Trade and other receivables, current                | 872,468                      | -  | -                                       | -  | 872,468            |
| Other financial assets, current                     | 147,972                      | -  | -                                       | -  | 147,972            |
| Long-term deposits                                  | 150,768                      | -  | -                                       | -  | 150,768            |
| Financial assets as available-for-sale, non-current | -                            | -  | -                                       | 275,431  | 275,431            |
| Long-term Trade and other receivables               | 128,651                      | -  | -                                       | -  | 128,651            |
| Other financial assets, non-current                 | 453                          | -  | -                                       | -  | 453                |
|   | <u>₩ 2,152,693</u>           | <u>₩ -</u>   | <u>₩ -</u>                              | <u>₩ 276,475</u>                               | <u>₩ 2,429,168</u> |

  

| <b>December 31, 2011</b>                            |                              |  |   |  |                    |
|---|------------------------------|--|---|--|--------------------|
| <i>(in millions of Korean won)</i>                  | <b>Loans and receivables</b> | <b>Assets at fair value through profit or loss</b> | <b>Derivative financial instruments</b> | <b>Assets classified as available-for-sale</b> | <b>Total</b>       |
| Cash and cash equivalents                           | ₩807,731                     | ₩ -  | ₩ -                                     | ₩ -  | ₩ 807,731          |
| Financial assets as available-for-sale, current     | -                            | -  | -                                       | 1,044  | 1,044              |
| Trade and other receivables, current                | 833,310                      | -  | -                                       | -  | 833,310            |
| Other financial assets, current                     | 11,089                       | -  | -                                       | -  | 11,089             |
| Long-term deposits                                  | 147,290                      | -  | -                                       | -  | 147,290            |
| Financial assets as available-for-sale, non-current | -                            | -  | -                                       | 247,359  | 247,359            |
| Long-term Trade and other receivables               | 134,115                      | -  | -                                       | -  | 134,115            |
| Other financial assets, non-current                 | 1,427                        | -  | -                                       | -  | 1,427              |
|   | <u>₩1,934,962</u>            | <u>₩ -</u>   | <u>₩ -</u>                              | <u>₩ 248,403</u>                               | <u>₩ 2,183,365</u> |

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

| <b>March 31, 2012</b>                   |   |   |  |                                    |                  |
|---|---|---|--|------------------------------------|------------------|
| <i>(in millions of Korean won)</i>      | <b>Liabilities at fair value through profit or loss</b> | <b>Derivative financial instruments</b> | <b>Other financial liabilities at amortized cost</b> | <b>Other financial liabilities</b> | <b>Total</b>     |
| Borrowings, current                     | ₩ -   | ₩ -                                     | ₩ 79,043   | ₩ -                                | ₩ 79,043         |
| Borrowings, non-current                 | -   | -                                       | 58,797   | -                                  | 58,797           |
| Current portion of long-term borrowings | -   | -                                       | 2,092  | -                                  | 2,092            |
| Trade and other payables, current       | -   | -                                       | 256,023  | -                                  | 256,023          |
| Trade and other payables, non-current   | -   | -                                       | 27,411   | -                                  | 27,411           |
|   | <u>₩ -</u>  | <u>₩ -</u>                              | <u>₩ 423,366</u>                                     | <u>₩ -</u>                         | <u>₩ 423,366</u> |

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| (in millions of Korean won)             | December 31, 2011                                |                                  |   |                             |   | Total   |
|---|--|----------------------------------|---|-----------------------------|---|---------|
|   | Liabilities at fair value through profit or loss | Derivative financial instruments | Other financial liabilities at amortized cost | Other financial liabilities |   |         |
| Borrowings, current                     | ₩ -  | ₩ -                              | ₩ 82,836                                      | ₩ -                         | ₩ | 82,836  |
| Borrowings, non-current                 | -  | -                                | 37,847  | -                           |   | 37,847  |
| Current portion of long-term borrowings | -  | -                                | 3,126   | -                           |   | 3,126   |
| Trade and other payables, current       | -  | -                                | 281,654                                       | -                           |   | 281,654 |
| Trade and other payables, non-current   | -  | -                                | 14,727  | -                           |   | 14,727  |
|   | ₩ -  | ₩ -                              | ₩ 420,190                                     | ₩ -                         | ₩ | 420,190 |

Income and loss of financial instruments by category for the three-month periods ended March 31, 2012 and 2011, are as follows:

| (in millions of Korean won)                                | March 31, 2012 | March 31, 2011 |
|--|----------------|----------------|
| Available-for-sale financial assets                        |                |                |
| Gain(Loss) on valuation (Other comprehensive income(loss)) | ₩ 20,325       | ₩ (13,659)     |
| Gain(Loss) on disposal(Profit or loss)                     | (9)            | -              |
| Gain(Loss) on disposal (Reclassification) <sup>1</sup>     | -              | -              |
| Interest income  | 5              | 12             |
| Dividend income  | 3,415          | 3,332          |
| Impairment   | -              | (3,988)        |
| Cash and cash equivalents                                  |                |                |
| Interest income  | 7,230          | 7,182          |
| Gain(Loss) on foreign currency Translation                 | 115            | 344            |
| Foreign currency transaction gain (loss)                   | (565)          | 5              |
| Trade and other receivables                                |                |                |
| Interest income  | 2,051          | 1,970          |
| Gain(Loss) on foreign currency Translation                 | (8,361)        | (11,625)       |
| Foreign currency transaction gain (loss)                   | (1,334)        | (2,203)        |
| Other financial liabilities at amortized cost              |                |                |
| Interest costs   | (3,929)        | (996)          |
| Gain(Loss) on foreign currency Translation                 | 559            | (342)          |
| Foreign currency transaction gain (loss)                   | ₩ 408          | ₩ (589)        |

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**7. Available-for-sale Financial Assets**

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

| <i>(in millions of Korean won)</i>   | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--------------------------------------|-----------------------|-----------------------|
| At January 1                         | ₩ 248,403             | ₩ 315,177             |
| Additions                            | 1,500                 | -                     |
| Net gains(losses) transfer to equity | 26,814                | (17,512)              |
| Transfer to others                   | -                     | (17,300)              |
| Impairment losses                    | -                     | (3,988)               |
| Disposals                            | (242)                 | -                     |
| At March 31                          | 276,475               | 276,377               |
| Less: current portion                | (1,044)               | (1,000)               |
| <b>Non-Current portion</b>           | <b>₩ 275,431</b>      | <b>₩ 275,377</b>      |

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

| <i>(in millions of Korean won)</i>                 | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|--|-----------------------|--------------------------|
| <b>Available-for-sale debt instruments:</b>        |                       |                          |
| Government and municipal bonds                     | ₩ 336                 | ₩ 336                    |
| Corporate bonds                                    | 3,540                 | 2,040                    |
| <b>Total available-for-sale debt instruments</b>   | <b>₩ 3,876</b>        | <b>₩ 2,376</b>           |
| <b>Available-for-sale equity instruments:</b>      |                       |                          |
| <b>Listed</b>                                      |                       |                          |
| Yonhap Television News(YTN)                        | 33,185                | 23,130                   |
| Oscotech, Inc.                                     | 1,690                 | 2,049                    |
| Shinhan Financial Group Co., Ltd.                  | 175,366               | 159,332                  |
| Rexahn Pharmaceuticals, Inc.                       | 3,854                 | 2,801                    |
|  | ₩ 214,095             | ₩ 187,312                |
| <b>Unlisted</b>                                    |                       |                          |
| Dream Hub PFV Co., Ltd.                            | 12,009                | 12,009                   |
| Others   | 46,495                | 46,706                   |
|  | ₩ 58,504              | ₩ 58,715                 |
| <b>Total available-for-sale equity instruments</b> | <b>₩ 272,599</b>      | <b>₩ 246,027</b>         |
| <b>Total available-for-sale financial assets</b>   | <b>₩ 276,475</b>      | <b>₩ 248,403</b>         |

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

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

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

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**8. Trade and Other Receivables**

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

| <i>(in millions of<br/>Korean won)</i> | <b>March 31, 2012</b> |                    | <b>December 31, 2011</b> |                    |
|--|-----------------------|--------------------|--------------------------|--------------------|
|  | <b>Current</b>        | <b>Non-current</b> | <b>Current</b>           | <b>Non-current</b> |
| Loans to employees                     | ₩ 10,333              | ₩ 30,185           | ₩ 13,424                 | ₩ 32,441           |
| Loans                                  | 1,914                 | 8,474              | 1,917                    | 8,540              |
| Other receivables                      | 60,844                | 22,489             | 62,910                   | 22,281             |
| Guarantee deposits                     | -                     | 67,503             | -                        | 70,853             |
| Accrued income                         | 1,498                 | -                  | 1,962                    | -                  |
| Trade receivables                      | 797,879               | -                  | 753,097                  | -                  |
|  | <u>₩ 872,468</u>      | <u>₩ 128,651</u>   | <u>₩ 833,310</u>         | <u>₩ 134,115</u>   |

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

| <i>(in millions of<br/>Korean won)</i> | <b>March 31, 2012</b> |                    | <b>December 31, 2011</b> |                    |
|--|-----------------------|--------------------|--------------------------|--------------------|
|  | <b>Current</b>        | <b>Non-current</b> | <b>Current</b>           | <b>Non-current</b> |
| Gross trade and other receivables      | ₩ 888,931             | ₩ 128,651          | ₩ 849,691                | ₩ 134,115          |
| Allowance account                      |                       |                    |                          |                    |
| -Loans                                 | (2,235)               | -                  | (199)                    | -                  |
| -Other receivables                     | (14,029)              | -                  | (2,235)                  | -                  |
| -Trade receivables                     | (199)                 | -                  | (13,947)                 | -                  |
|  | <u>(16,463)</u>       | <u>-</u>           | <u>(16,381)</u>          | <u>-</u>           |
| Net amount                             | <u>₩ 872,468</u>      | <u>₩ 128,651</u>   | <u>₩ 833,310</u>         | <u>₩ 134,115</u>   |

Changes in the allowance account for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|------------------------------------|-----------------------|-----------------------|
| Beginning                          | ₩ 16,381              | ₩ 8,809               |
| Impairment                         | 199                   | 132                   |
| Reversal of impairment             | (117)                 | -                     |
| Write-off                          | -                     | -                     |
| Net exchange difference            | -                     | (9)                   |
| Ending                             | <u>₩ 16,463</u>       | <u>₩ 8,932</u>        |

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Impairment losses and reversal of impairment losses on trade and other receivables are included as part of other expense and income in the consolidated statements of comprehensive income. The aging schedule of trade and other receivables as of March 31, 2012 and December 31, 2011, is as follows:

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|------------------------------------|-----------------------|--------------------------|
| Not past due                       | ₩ 472,351             | ₩ 534,899                |
| Past due but not impaired          |                       |                          |
| Within 1 month                     | 119,834               | 59,256                   |
| Between 1 and 2 months             | 47,802                | 58,873                   |
| Beyond 2 months                    | 157,892               | 100,069                  |
|                                    | <u>325,528</u>        | <u>218,198</u>           |
| Impaired                           | 14,029                | 13,947                   |
|                                    | <u>₩ 811,908</u>      | <u>₩ 767,044</u>         |

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

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

| <i>(Number of shares)</i> | <b>March 31, 2012</b>          |                 |                    | <b>December 31, 2011</b>       |                 |                    |
|---------------------------|--------------------------------|-----------------|--------------------|--------------------------------|-----------------|--------------------|
|                           | <b>Effective interest rate</b> | <b>Current</b>  | <b>Non-current</b> | <b>Effective interest rate</b> | <b>Current</b>  | <b>Non-current</b> |
| Loans to employees        | 3.00~5.68%                     | ₩ 10,333        | ₩ 30,185           | 3.00~5.68%                     | ₩ 13,422        | ₩ 32,427           |
| Loans                     | 1.70~7.29%                     | 1,338           | 4,628              | 3.13~7.29%                     | 1,521           | 4,673              |
| Other receivables         | 3.79%                          |                 |                    | 3.79%                          |                 |                    |
| Guarantee deposits        | 1.70~8.47%                     | -               | 68,530             | 2.50~7.29%                     | -               | 67,661             |
|                           |                                | <u>₩ 11,671</u> | <u>₩ 125,832</u>   |                                | <u>₩ 22,940</u> | <u>₩ 127,042</u>   |

## **9. Long-term Deposits**

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

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|------------------------------------|-----------------------|--------------------------|
| MMF                                | ₩ 150,768             | ₩ 147,290                |

As discussed in Note 32 to the consolidated financial statements, long-term deposits in MSA Escrow Fund are deposited to the United States government related to the export of tobacco to the United States. The payments of long-term deposits in MSA Escrow Fund for the three-month periods ended March 31, 2012 and 2011, are ₩5,437 million and ₩2,859 million, respectively.

Investment income on long-term deposits in MSA Escrow Fund for the three-month periods ended March 31, 2012 and 2011, are ₩70 million and ₩302 million, respectively.

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

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**10. Property, Plant and Equipment**

Changes in property, plant and equipment for the three-month periods ended March 31, 2012 and 2011, are as follows:

| (in millions of Korean won) | March 31, 2012   |  |                |
|-----------------------------|------------------|--|----------------|
|                             | Acquisition Cost | Accumulated depreciation and impairment cost | Net book value |
| Land                        | ₩ 460,851        | ₩ -  | ₩ 460,851      |
| Buildings                   | 829,719          | (302,017)                                    | 527,702        |
| Structures                  | 65,518           | (35,662)                                     | 29,856         |
| Machinery                   | 1,065,450        | (712,350)                                    | 353,100        |
| Vehicles                    | 12,237           | (8,900)                                      | 3,337          |
| Tools                       | 49,870           | (41,115)                                     | 8,755          |
| Furniture and fixture       | 241,212          | (173,992)                                    | 67,220         |
| Others                      | 1,219            | -  | 1,219          |
| Construction-in-progress    | 123,564          | -  | 123,564        |
|                             | ₩ 2,849,640      | ₩ (1,274,036)                                | ₩ 1,575,604    |

| (in millions of Korean won) | March 31, 2011   |  |                |
|-----------------------------|------------------|--|----------------|
|                             | Acquisition Cost | Accumulated depreciation and impairment cost | Net book value |
| Land                        | ₩ 449,731        | ₩ -  | ₩ 449,731      |
| Buildings                   | 760,111          | (265,974)                                    | 494,137        |
| Structures                  | 63,345           | (32,108)                                     | 31,237         |
| Machinery                   | 992,618          | (625,294)                                    | 367,324        |
| Vehicles                    | 8,211            | (6,390)                                      | 1,821          |
| Tools                       | 45,720           | (34,869)                                     | 10,851         |
| Furniture and fixture       | 196,774          | (140,039)                                    | 56,735         |
| Others                      | 902              | -  | 902            |
| Construction-in-progress    | 88,008           | -  | 88,008         |
|                             | ₩ 2,605,420      | ₩ (1,104,674)                                | ₩ 1,500,746    |

| (in millions of Korean won) | March 31, 2012         |           |                           |           |              |                     |                       |                 |
|-----------------------------|------------------------|-----------|---------------------------|-----------|--------------|---------------------|-----------------------|-----------------|
|                             | Opening net book value | Additions | Acquisition of subsidiary | Disposal  | Depreciation | Exchange difference | Transfer <sup>1</sup> | Net book amount |
| Land                        | ₩ 460,487              | ₩ 457     | ₩ -                       | ₩ (181)   | ₩ -          | ₩ 457               | ₩ (369)               | ₩ 460,851       |
| Buildings                   | 532,066                | 1,071     | -                         | (1,319)   | (9,317)      | 4,002               | 1,199                 | 527,702         |
| Structures                  | 30,072                 | -         | -                         | (179)     | (880)        | 181                 | 662                   | 29,856          |
| Machinery                   | 365,040                | 1,462     | 165                       | (141)     | (18,877)     | 1,212               | 4,239                 | 353,100         |
| Vehicles                    | 3,547                  | 154       | 9                         | (23)      | (1,040)      | 690                 | -                     | 3,337           |
| Tools                       | 9,871                  | 155       | 113                       | -         | (1,286)      | (98)                | -                     | 8,755           |
| Furniture and fixture       | 66,299                 | 9,130     | 10                        | (387)     | (7,779)      | (129)               | 76                    | 67,220          |
| Others                      | 1,219                  | 0         | -                         | -         | -            | -                   | -                     | 1,219           |
| Construction-in-progress    | 115,745                | 19,809    | -                         | (226)     | -            | (45)                | (11,719)              | 123,564         |
|                             | ₩ 1,584,346            | ₩ 32,238  | ₩ 297                     | ₩ (2,456) | ₩ (39,179)   | ₩ 6,270             | ₩ (5,912)             | ₩ 1,575,604     |

| (in millions of Korean won) | March 31, 2011         |           |                           |           |              |                     |            |                 |
|-----------------------------|------------------------|-----------|---------------------------|-----------|--------------|---------------------|------------|-----------------|
|                             | Opening net book value | Additions | Acquisition of subsidiary | Disposal  | Depreciation | Exchange difference | Transfer   | Net book amount |
| Land                        | ₩ 436,950              | ₩ 18      | ₩ -                       | ₩ (1,174) | ₩ -          | ₩ 134               | ₩ -        | ₩ 449,731       |
| Buildings                   | 496,353                | 306       | -                         | (197)     | (5,147)      | 1,473               | (5,147)    | 494,137         |
| Structures                  | 32,047                 | 39        | -                         | (70)      | (797)        | 110                 | (797)      | 31,237          |
| Machinery                   | 381,380                | 636       | -                         | (42)      | (18,291)     | 710                 | (18,291)   | 367,324         |
| Vehicles                    | 1,789                  | 203       | -                         | (1)       | (212)        | 13                  | (212)      | 1,821           |
| Tools                       | 12,166                 | 32        | -                         | -         | (1,347)      | -                   | (1,347)    | 10,851          |
| Furniture and fixture       | 60,015                 | 4,184     | -                         | (66)      | (7,845)      | (21)                | (7,845)    | 56,735          |
| Others                      | 749                    | -         | -                         | (10)      | -            | -                   | -          | 902             |
| Construction-in-progress    | 89,389                 | 47,931    | -                         | -         | -            | (3)                 | -          | 88,008          |
|                             | ₩ 1,510,838            | ₩ 53,349  | ₩ -                       | ₩ (1,560) | ₩ (33,639)   | ₩ 2,416             | ₩ (33,639) | ₩ 1,500,746     |

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<sup>1</sup> Transfers for the three-month period ended March 31, 2012, include assets with a carrying amount of ₩10,753 million transferred from investment property, while ₩4,863 million were transferred to assets held for sale.

**11. Intangible Assets**

Changes in intangible assets for three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i>           | March 31, 2012  |                            |                       |                         |                                     |                  |
|--|-----------------|----------------------------|-----------------------|-------------------------|-------------------------------------|------------------|
|  | Goodwill        | Industrial property rights | Facility usage rights | Other intangible assets | Intangible assets under development | Total            |
| <b>At January 1, 2012</b>                    | ₩ 87,902        | ₩ 23,454                   | ₩ 24,387              | ₩ 106,641               | ₩ 16,234                            | ₩ 258,618        |
| Exchange differences                         | (717)           | (38)                       | (1)                   | (63)                    | -                                   | (819)            |
| Additions                                    | -               | 26                         | 2                     | 410                     | 208                                 | 646              |
| Acquisition of subsidiary                    | -               | 25                         | -                     | -                       | -                                   | 25               |
| Transfer-in (out)                            | -               | 30                         | -                     | 22                      | (30)                                | 22               |
| Disposals                                    | -               | (70)                       | -                     | (53)                    | (667)                               | (790)            |
| Amortization                                 | -               | (716)                      | -                     | (1,875)                 | -                                   | (2,591)          |
| Impairment / reversal                        | -               | -                          | -                     | -                       | -                                   | -                |
| Other Changes                                | -               | 12,398                     | -                     | -                       | (12,398)                            | -                |
| Acquisition Cost                             | 87,185          | 44,089                     | 24,388                | 116,841                 | 3,774                               | 276,277          |
| Accumulated depreciation and impairment cost | -               | (8,980)                    | -                     | (11,759)                | (427)                               | (21,166)         |
| <b>Net book amount</b>                       | <u>₩ 87,185</u> | <u>₩ 35,109</u>            | <u>₩ 24,388</u>       | <u>₩ 105,082</u>        | <u>₩ 3,347</u>                      | <u>₩ 255,111</u> |

  

| <i>(in millions of Korean won)</i>           | March 31, 2011             |                       |                         |                                     |                 |
|--|----------------------------|-----------------------|-------------------------|-------------------------------------|-----------------|
|  | Industrial property rights | Facility usage rights | Other intangible assets | Intangible assets under development | Total           |
| <b>At January 1, 2011</b>                    | ₩ 2,049                    | ₩ 24,189              | ₩ 4,194                 | ₩ 32,713                            | ₩ 63,145        |
| Exchange differences                         | -                          | -                     | -                       | -                                   | -               |
| Additions                                    | 240                        | 6                     | 274                     | 299                                 | 819             |
| Acquisition of subsidiary                    | -                          | -                     | -                       | -                                   | -               |
| Transfer-in (out)                            | -                          | -                     | -                       | -                                   | -               |
| Disposals                                    | (16)                       | (2,962)               | -                       | -                                   | (2,978)         |
| Amortization                                 | (17)                       | -                     | (382)                   | -                                   | (399)           |
| Impairment / reversal                        | -                          | -                     | -                       | -                                   | -               |
| Other Changes                                | 52                         | -                     | -                       | (52)                                | -               |
| Acquisition Cost                             | 10,220                     | 21,233                | 16,025                  | 33,607                              | 81,085          |
| Accumulated depreciation and impairment cost | (7,912)                    | -                     | (11,939)                | (647)                               | (20,498)        |
| <b>Net book amount</b>                       | <u>₩ 2,308</u>             | <u>₩ 21,233</u>       | <u>₩ 4,086</u>          | <u>₩ 32,960</u>                     | <u>₩ 60,587</u> |

Research and development expenses for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i>  | March 31, 2012 | March 31, 2011 |
|-------------------------------------|----------------|----------------|
| Cost of goods sold                  | ₩ 2,107        | ₩ 172          |
| Selling and administrative expenses | 7,873          | 5,167          |
|                                     | <u>₩ 9,980</u> | <u>₩ 5,339</u> |

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Exchange loss of ₩717 million arising from the translation of goodwill of PT Trisakti Purwosari Makmur, one of subsidiaries, is accounted for as a deduction from goodwill and loss on translation of overseas operations.

**12. Investment Property**

Changes in investment property for the three-month periods ended March 31, 2012 and 2011, are as follows:

*(in millions of Korean won)*

|   | <b>March 31, 2012</b> |                 |              |
|---|-----------------------|-----------------|--------------|
|   | <b>Land</b>           | <b>Building</b> | <b>Total</b> |
| Beginning net book value                  | ₩ 45,314              | ₩ 143,037       | ₩ 188,351    |
| Transfer to property, plant and equipment | (562)                 | (4,301)         | (4,863)      |
| Depreciation                              | -                     | (1,551)         | (1,551)      |
| Acquisition cost                          | 44,752                | 177,979         | 222,731      |
| Accumulated depreciation                  | -                     | (40,794)        | (40,794)     |
| Net book amount                           | ₩ 44,752              | ₩ 137,185       | ₩ 181,937    |

*(in millions of Korean won)*

|   | <b>March 31, 2011</b> |                 |              |
|---|-----------------------|-----------------|--------------|
|   | <b>Land</b>           | <b>Building</b> | <b>Total</b> |
| Beginning net book value                    | ₩ 36,550              | ₩ 84,933        | ₩ 121,483    |
| Transfer to property, plant and equipment   | -                     | 1,221           | 1,221        |
| Transfer from property, plant and equipment | (268)                 | (290)           | (558)        |
| Depreciation                                | 1,481                 | 24,025          | 25,506       |
| Acquisition cost                            | 37,763                | 146,673         | 184,436      |
| Accumulated depreciation                    | -                     | (37,842)        | (37,842)     |
| Net book amount                             | ₩ 37,763              | ₩ 108,831       | ₩ 146,594    |

The amounts recognized in profit or loss from investment property for the three-month periods ended March 31, 2012 and 2011, are as follows:

*(in millions of Korean won)*

|                          | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--------------------------|-----------------------|-----------------------|
| Rental income            | ₩ 7,205               | ₩ 21,243              |
| Direct operating expense | (1,551)               | (5,013)               |
|                          | ₩ 5,654               | ₩ 16,230              |

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

*(in millions of Korean won)*

|          | <b>March 31, 2012</b> |                   | <b>December 31, 2011</b> |                   |
|----------|-----------------------|-------------------|--------------------------|-------------------|
|          | <b>Fair value</b>     | <b>Book value</b> | <b>Fair value</b>        | <b>Book value</b> |
| Land     | ₩ 351,365             | ₩ 44,752          | ₩ 313,922                | ₩ 45,314          |
| Building | 208,398               | 137,185           | 198,204                  | 143,037           |
|          | ₩ 559,763             | ₩ 181,937         | ₩ 512,126                | ₩ 188,351         |



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

The Group enters into a sales contract with HT&D Co., Ltd to sell the Gyeonggi branch's land, building and others. The Group received partial payment amounting to ₩1,500 million out of total amount ₩17,820 million during the three-month period ended March 31, 2012, and has agreed to receive in installments the balance of ₩16,320 million after the current period.

Also, the Group has an agreement with Mr. Jae-chil Kim and two others for sale of Namulsan Tower's land, building and others. In related to this contract, the Group recognizes non-current assets held for sale as the lower of net fair value and book value.

Changes in non-current assets held for sale for the three-month period ended March 31, 2012, are as follows:

| (in millions of<br>Korean won)                    | March 31, 2012 |           |            |           |          |
|---|----------------|-----------|------------|-----------|----------|
|   | Land           | Buildings | Structures | Machinery | Total    |
| <b>At January 1</b>                               |                |           |            |           |          |
| Acquisition cost                                  | ₩ 2,273        | ₩ 1,429   | ₩ 197      | ₩ -       | ₩ 3,899  |
| Accumulated depreciation                          | -              | (553)     | (150)      | -         | (703)    |
| Net book amount                                   | ₩ 2,273        | ₩ 876     | ₩ 47       | ₩ -       | ₩ 3,196  |
| <b>Changes</b>                                    |                |           |            |           |          |
| Transfer from<br>property, plant and<br>equipment | ₩ 6,235        | ₩ 4,418   | ₩ 55       | ₩ 45      | ₩ 10,753 |
|   | ₩ 6,235        | ₩ 4,418   | ₩ 55       | ₩ 45      | ₩ 10,753 |
| <b>At March 31</b>                                |                |           |            |           |          |
| Acquisition cost                                  | ₩ 8,508        | ₩ 8,500   | ₩ 407      | ₩ 196     | ₩ 17,611 |
| Accumulated depreciation                          | -              | (3,206)   | (305)      | (151)     | (3,662)  |
| Net book amount                                   | ₩ 8,508        | ₩ 5,294   | ₩ 102      | ₩ 45      | ₩ 13,949 |

**14. Pledged Assets**

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

| (in millions of Korean won)         |           |                          |                    |                          |  |
|-------------------------------------|-----------|--------------------------|--------------------|--------------------------|--|
| Asset                               | Amount    |                          | Received<br>amount | Collateralized<br>amount | Lender<br>/Leaseholder                               |
| Property, plant<br>and equipment    | ₩ 109,631 | Short-term<br>borrowings | ₩ 53,488           | ₩ 94,355                 | Hana Bank<br>and 4 others                            |
| Investment                          |           | Long-term<br>borrowings  | 10,157             |                          |  |
| Property                            | 150,435   | Leasehold<br>deposits    | 8,407              | 9,032                    | Metlife Insurance<br>Korea Co.,Ltd.<br>and 31 others |
| Investment Property                 |           | received                 |                    |                          |  |
| Non-current Assets<br>Held for Sale |           |                          |                    |                          |  |
| <b>Total</b>                        | ₩ 264,177 |                          | ₩ 72,052           | ₩ 103,387                |  |

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

(in millions of Korean won)

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

**15. Investments in Associates**

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

(in millions of Korean won)

| Associates                           | Location | Principal operation                | March 31, 2012 |                 | December 31, 2011 |                 |
|--------------------------------------|----------|------------------------------------|----------------|-----------------|-------------------|-----------------|
|                                      |          |                                    | Interest       | Carrying Amount | Interest          | Carrying Amount |
| Cosmo Tobacco Co., Ltd.              | Mongolia | Manufacturing and Selling tobaccos | 40.00%         | ₩ -             | 40.00%            | ₩ -             |
| Lite Pharm Tech, Inc.                | Korea    | Manufacturing and Medical supplies | 25.34%         | 620             | 25.34%            | 637             |
| Korean Carbon Finance, Inc.          | Korea    | Emissions trading                  | 20.00%         | 987             | 20.00%            | 1,013           |
| JR CR-REIT IV Co., Ltd.              | Korea    | Selling and renting of real estate | 49.02%         | 14,926          | 49.02%            | 13,819          |
| KVG REIT 1 Co., Ltd.                 | Korea    | Selling and renting of real estate | 29.67%         | 7,184           | 29.67%            | 7,354           |
| KOCREF REIT 17 Co., Ltd.             | Korea    | Selling and renting of real estate | 22.06%         | 6,804           | 22.06%            | 6,872           |
| JR REIT V Co., Ltd.                  | China    | Selling and renting of real estate | 34.63%         | 5,724           | 34.63%            | 5,635           |
| JR REIT VIII Co., Ltd.               | Korea    | Selling and renting of real estate | 21.74%         | 9,944           | -                 | -               |
| LSK Global Pharma Services Co., Ltd. | Korea    | Research and developing new drug   | 23.15%         | 1,500           | -                 | -               |
| <b>Total</b>                         |          |                                    |                | <u>₩ 47,689</u> |                   | <u>₩ 35,330</u> |

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Changes in investments in associates for the three-month periods ended March 31, 2012 and 2011, are as follows:

| (in millions of<br>Korean won)          | March 31, 2012       |                 |                          |                  |                   |
|---|----------------------|-----------------|--------------------------|------------------|-------------------|
|   | Beginning<br>balance | Acquisition     | Share of<br>profit(loss) | Other<br>changes | Ending<br>balance |
| Lite Pharm Tech, Inc.                   | ₩ 637                | ₩               | ₩ (17)                   | ₩ -              | ₩ 620             |
| Korean Carbon<br>Finance, Inc.          | 1,013                | -               | (25)                     | -                | 988               |
| JR CR-REIT IV<br>Co., Ltd.              | 13,819               | -               | 1,106                    | -                | 14,925            |
| KVG REIT 1 Co., Ltd.                    | 7,354                | -               | 91                       | (262)            | 7,183             |
| KOCREF REIT 17<br>Co., Ltd.             | 6,872                | -               | (68)                     | -                | 6,804             |
| JR REIT V Co., Ltd.                     | 5,635                | -               | 90                       | -                | 5,725             |
| JR REIT VIII Co., Ltd.                  | -                    | 10,000          | (56)                     | -                | 9,944             |
| LSK Global Pharma<br>Services Co., Ltd. | -                    | 1,500           | -                        | -                | 1,500             |
| <b>Total</b>                            | <u>₩ 35,330</u>      | <u>₩ 11,500</u> | <u>₩ 1,121</u>           | <u>₩ (262)</u>   | <u>₩ 47,689</u>   |

| (in millions of<br>Korean won) | March 31, 2011       |                 |                          |                               |                   |
|--------------------------------|----------------------|-----------------|--------------------------|-------------------------------|-------------------|
|                                | Beginning<br>balance | Acquisition     | Share of<br>profit(loss) | Other<br>changes <sup>1</sup> | Ending<br>balance |
| Lite Pharm Tech, Inc.          | ₩ 645                | ₩ -             | ₩ (8)                    | ₩ -                           | ₩ 637             |
| Korean Carbon<br>Finance, Inc. | 952                  | -               | (25)                     | -                             | 927               |
| JR CR-REIT IV<br>Co., Ltd.     | -                    | -               | 93                       | 10,000                        | 10,093            |
| KVG REIT 1 Co., Ltd.           | -                    | -               | (93)                     | 7,300                         | 7,207             |
| KOCREF REIT 17<br>Co., Ltd.    | -                    | 7,000           | 180                      | -                             | 7,180             |
| JR REIT V Co., Ltd.            | -                    | 5,600           | (10)                     | -                             | 5,590             |
| <b>Total</b>                   | <u>₩ 1,597</u>       | <u>₩ 12,600</u> | <u>₩ 137</u>             | <u>₩ 17,300</u>               | <u>₩ 31,634</u>   |

<sup>1</sup>The Group reclassified ₩17,300 million of available-for-sale financial assets to equity-method investments during the three-month period ended March 31, 2011.

The Company's share in the results of its associates, and its aggregated assets (including goodwill) and liabilities as of March 31, 2012 and December 31, 2011, are as follows:

| (In millions of Korean won)          | March 31, 2012   |                  |                |               |
|--------------------------------------|------------------|------------------|----------------|---------------|
|                                      | Assets           | Liabilities      | Revenues       | Profit/(loss) |
| Lite Pharm Tech, Inc.                | ₩ 3,956          | ₩ 1,509          | ₩ 861          | ₩ 259         |
| Korean Carbon<br>Finance, Inc.       | 4,977            | 39               | 89             | (114)         |
| JR CR-REIT IV Co., Ltd.              | 66,158           | 35,710           | 1,328          | 385           |
| KVG REIT 1 Co., Ltd.                 | 52,266           | 28,058           | 1,433          | 278           |
| KOCREF REIT 17<br>Co., Ltd.          | 66,769           | 35,927           | 766            | (307)         |
| JR REIT V Co., Ltd.                  | 31,753           | 15,221           | 545            | 259           |
| JR REIT VIII Co., Ltd.               | 100,010          | 54,269           | 133            | (30)          |
| LSK Global Pharma Services Co., Ltd. | 5,315            | 2,758            | 2,019          | 179           |
|                                      | <u>₩ 331,204</u> | <u>₩ 173,491</u> | <u>₩ 7,174</u> | <u>₩ 909</u>  |

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*(In millions of Korean won)*

|                             | <b>December 31, 2011</b> |                    |                 |                      |
|-----------------------------|--------------------------|--------------------|-----------------|----------------------|
|                             | <b>Assets</b>            | <b>Liabilities</b> | <b>Revenues</b> | <b>Profit/(loss)</b> |
| Lite Pharm Tech, Inc.       | ₩ 4,041                  | ₩ 1,527            | ₩ 1,549         | ₩ (32)               |
| Korean Carbon Finance, Inc. | 5,158                    | 97                 | 1,143           | 303                  |
| JR CR-REIT IV Co., Ltd.     | 65,722                   | 35,658             | 6,758           | 1,583                |
| KVG REIT 1 Co., Ltd.        | 52,829                   | 28,045             | 5,540           | 993                  |
| KOCREF REIT 17 Co., Ltd.    | 65,749                   | 34,600             | 128             | 441                  |
| JR REIT V Co., Ltd.         | 31,480                   | 15,208             | 540             | 831                  |
|                             | <u>₩ 224,979</u>         | <u>₩ 115,135</u>   | <u>₩ 15,658</u> | <u>₩ 4,119</u>       |

**16. Inventories**

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

| <i>(In millions of Korean won)</i> | <b>March 31, 2012</b> |                  |                    | <b>December 31, 2011</b> |                  |                    |
|------------------------------------|-----------------------|------------------|--------------------|--------------------------|------------------|--------------------|
|                                    | <b>Acquisition</b>    | <b>Allowance</b> | <b>Book amount</b> | <b>Acquisition</b>       | <b>Allowance</b> | <b>Book amount</b> |
| Merchandise                        | ₩ 6,509               | ₩ (950)          | ₩ 5,559            | ₩ 5,678                  | ₩ (881)          | ₩ 4,797            |
| Finished goods                     | 348,975               | (1,645)          | 347,330            | 307,308                  | (1,782)          | 305,526            |
| Work in progress                   | 238,824               | (3,603)          | 235,221            | 328,087                  | (3,647)          | 324,440            |
| Raw materials                      | 844,405               | (2,624)          | 841,781            | 874,359                  | (2,974)          | 871,385            |
| Supplies                           | 25,687                | -                | 25,687             | 26,158                   | -                | 26,158             |
| By-products                        | 6,566                 | -                | 6,566              | 6,738                    | -                | 6,738              |
| Goods-in-transit                   | 18,466                | -                | 18,466             | 33,255                   | -                | 33,255             |
|                                    | <u>₩ 1,489,432</u>    | <u>₩ (8,822)</u> | <u>₩ 1,480,610</u> | <u>₩ 1,581,583</u>       | <u>₩ (9,284)</u> | <u>₩ 1,572,299</u> |

The cost related inventories for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i>   | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--------------------------------------|-----------------------|-----------------------|
| Cost of sales                        |                       |                       |
| -Loss(profit) on inventory valuation | ₩ (351)               | ₩ 589                 |
| Other expenses                       |                       |                       |
| - Loss on retirement of inventories  |                       |                       |
| Capitalization of borrowing costs    | 1,623                 | 688                   |
|                                      | <u>₩ 1,272</u>        | <u>₩ 1,277</u>        |

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**17. Cash and Cash Equivalents**

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

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|------------------------------------|-----------------------|--------------------------|
| Cash on hand                       | ₩ 6,129               | ₩ 4,554                  |
| Demand deposits                    | 189,809               | 213,845                  |
| Short-term investment assets       | 656,443               | 589,332                  |
|                                    | <u>₩ 852,381</u>      | <u>₩ 807,731</u>         |

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

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|------------------------------------|-----------------------|--------------------------|
| <b>Short-term Financial assets</b> |                       |                          |
| Time deposits                      | ₩ 27,425              | ₩ 4,869                  |
| Money trust                        | 66,000                | -                        |
| Certificate of deposit             | 55,000                | 7,647                    |
|                                    | <u>₩ 148,425</u>      | <u>₩ 12,516</u>          |

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

| <i>(In millions of Korean won)</i> | <b>Description</b>        | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|------------------------------------|---------------------------|-----------------------|--------------------------|
| Cash and cash equivalents          | Specific research purpose | ₩ 648                 | ₩ -                      |
| Other financial assets             | Pledge                    | 8,657                 | 9,677                    |
| Long-term other financial assets   | Deposits                  | 20                    | 34                       |
| Long-term other financial assets   | Pledge                    | 360                   | -                        |
|                                    |                           | <u>₩ 9,685</u>        | <u>₩ 9,711</u>           |

**18. Equity and Share Premium**

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

| <i>(in Korean won, except number of shares)</i> | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|---|-----------------------|--------------------------|
| Number of ordinary shares                       |                       |                          |
| -Authorized                                     | 800,000,000           | 800,000,000              |
| -Issued   | 137,292,497           | 137,292,497              |
| Par value                                       | ₩ 5,000               | ₩ 5,000                  |
| Ordinary shares                                 | ₩ 954,959,485,000     | ₩ 954,959,485,000        |

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

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Changes in the number of shares for the three-month period ended March 31, 2012 and the year ended December 31, 2011, are as follows:

| (Number of shares)             | March 31, 2012     |                     |                    | December 31, 2011  |                     |                    |
|--------------------------------|--------------------|---------------------|--------------------|--------------------|---------------------|--------------------|
|                                | Ordinary shares    | Treasury shares     | Total              | Ordinary shares    | Treasury shares     | Total              |
| Beginning                      | 137,292,497        | (11,543,697)        | 125,748,800        | 137,292,497        | (9,643,697)         | 127,648,800        |
| Acquisition of treasury shares | -                  | -                   | -                  | -                  | (2,000,000)         | (2,000,000)        |
| Issuance of treasury shares    | -                  | -                   | -                  | -                  | 100,000             | 100,000            |
| Ending                         | <u>137,292,497</u> | <u>(11,543,697)</u> | <u>125,748,800</u> | <u>137,292,497</u> | <u>(11,543,697)</u> | <u>125,748,800</u> |

Changes in the other capital surplus for the three-month period ended March 31, 2012 and the year ended December 31, 2011 are as follows:

(in millions of Korean won)

|  | March 31, 2012 |              | December 31, 2011 |              |
|--|----------------|--------------|-------------------|--------------|
| Beginning  | ₩              | 5,333        | ₩                 | 5,333        |
| Transfer of conversion option value to capital surplus |                | 4,204        |                   | -            |
| Ending   | ₩              | <u>9,537</u> | ₩                 | <u>5,333</u> |

## 19. Treasury Shares

Changes in the treasury shares for the three-month period ended March 31, 2012 and the year ended December 31, 2011, are as follows:

(in millions of Korean won)

|                                | March 31, 2012    |                  | December 31, 2011 |                  |
|--------------------------------|-------------------|------------------|-------------------|------------------|
|                                | Number of shares  | Carrying amount  | Number of shares  | Carrying amount  |
| Beginning                      | 11,543,697        | ₩ 343,522        | 9,643,697         | ₩ 216,827        |
| Acquisition of treasury shares | -                 | -                | 2,000,000         | 129,671          |
| Issuance of treasury shares    | -                 | -                | (100,000)         | (2,976)          |
| Ending                         | <u>11,543,697</u> | <u>₩ 343,522</u> | <u>11,543,697</u> | <u>₩ 343,522</u> |

Changes in gain on reissuance of treasury shares for the three-month period ended March 31, 2012 and the year ended December 31, 2011, are as follows:

(in millions of Korean won)

|   | March 31, 2012 |                | December 31, 2011 |                |
|---|----------------|----------------|-------------------|----------------|
| Beginning   | ₩              | 485,922        | ₩                 | 482,129        |
| Gain on reissuance of treasury shares before tax  |                | -              |                   | 5,004          |
| Less: tax at 24.2%                                |                | -              |                   | (1,211)        |
| Gain on reissuance of treasury shares, net of tax |                | -              |                   | 3,793          |
| Ending  | ₩              | <u>485,922</u> | ₩                 | <u>485,922</u> |

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**20. Reserves**

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

| <i>(in millions of Korean won)</i>                        | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|---|-----------------------|--------------------------|
| Available-for-sale financial assets reserve               | ₩ (11,529)            | ₩ (31,855)               |
| Exchange differences<br>on translating foreign operations | (8,335)               | (15,501)                 |
| Legal reserve   | 602,937               | 602,937                  |
| Voluntary reserve   | 2,466,732             | 2,107,732                |
|   | <u>₩ 3,049,805</u>    | <u>₩ 2,663,313</u>       |

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

| <i>(in millions of Korean won)</i>                     | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|--|-----------------------|--------------------------|
| Available-for-sale financial assets reserve before tax | ₩ (15,210)            | ₩ (42,025)               |
| Tax effect   | 3,681                 | 10,170                   |
|  | <u>₩ (11,529)</u>     | <u>₩ (31,855)</u>        |

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

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

| <i>(in millions of Korean won)</i>                     | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|--|-----------------------|--------------------------|
| Reserve for business rationalization                   | ₩ 12,851              | ₩ 12,851                 |
| Reserve for research and<br>human resource development | 60,000                | 60,000                   |
| Reserve for business expansion                         | 698,881               | 698,881                  |
| Other reserve  | 1,695,000             | 1,336,000                |
|  | <u>₩ 2,466,732</u>    | <u>₩ 2,107,732</u>       |

*Reserve for Business Rationalization*

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

*Reserve for Research and Human Resource Development*

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

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*Reserve for Business Expansion and other reserve*

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

**21. Retained Earnings**

Changes in retained earnings for the three-month period ended March 31, 2012 and the year ended December 31, 2011, are as follows:

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> |                | <b>December 31, 2011</b> |                  |
|------------------------------------|-----------------------|----------------|--------------------------|------------------|
| Beginning                          | ₩                     | 1,022,126      | ₩                        | 1,151,359        |
| Transfer from other reserve        |                       | (359,000)      |                          | (544,000)        |
| Dividends                          |                       | (402,396)      |                          | (382,946)        |
| Profit for the period              |                       | 186,254        |                          | 816,929          |
| - Less: non-controlling interests  |                       | (4,567)        |                          | (871)            |
| Actuarial losses, net of tax       |                       | (178)          |                          | (19,449)         |
| - Less: non-controlling interests  |                       | 9,135          |                          | 1,104            |
| Ending                             | ₩                     | <u>451,374</u> | ₩                        | <u>1,022,126</u> |

**22. Accounts Payable and Other Finance Liabilities**

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

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> |                    | <b>December 31, 2011</b> |                    |
|------------------------------------|-----------------------|--------------------|--------------------------|--------------------|
|                                    | <b>Current</b>        | <b>Non-current</b> | <b>Current</b>           | <b>Non-current</b> |
| Leasehold deposits received        | ₩ -                   | ₩ 27,136           | ₩ 154                    | ₩ 25,069           |
| Accounts payable                   | 90,411                | -                  | 81,938                   | -                  |
| Withholdings                       | 150,169               | -                  | 137,344                  | 644                |
| Accrued expenses                   | 101,648               | -                  | 131,775                  | -                  |
| Other payable                      | 63,510                | 275                | 71,523                   | 318                |
|                                    | <u>₩ 405,738</u>      | <u>₩ 27,411</u>    | <u>₩ 422,734</u>         | <u>₩ 26,031</u>    |

Accounts payable and other finance liabilities carried at amortized cost using the effective interest rate method as of March 31, 2012 and December 31, 2011, are as follows:

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b>             |                |                    | <b>December 31, 2011</b>          |                |                    |
|------------------------------------|-----------------------------------|----------------|--------------------|-----------------------------------|----------------|--------------------|
|                                    | <b>Effective interest rate(%)</b> | <b>Current</b> | <b>Non-current</b> | <b>Effective interest rate(%)</b> | <b>Current</b> | <b>Non-current</b> |
| Leasehold deposits received        | 3.00~5.68                         | ₩ -            | ₩ 27,136           | 3.00~5.68                         | ₩ -            | ₩ 25,069           |



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**23. Borrowings**

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

*(in millions of Korean won)*

|  | <b>March 31, 2012</b> |                | <b>December 31, 2011</b> |                |
|--|-----------------------|----------------|--------------------------|----------------|
| <b>Current</b>   |                       |                |                          |                |
| Bank borrowings  | ₩                     | 71,228         | ₩                        | 75,021         |
| Other borrowings   |                       | 7,815          |                          | 7,815          |
| Bank borrowings(Current portion of long-term borrowings)   |                       | 503            |                          | 549            |
| Other borrowings (Current portion of long-term borrowings) |                       | 1,589          |                          | 1,619          |
| Convertible bonds  |                       | -              |                          | 958            |
|  |                       | <u>81,135</u>  |                          | <u>85,962</u>  |
| <b>Non-current</b>   |                       |                |                          |                |
| Bank borrowings  |                       | 10,013         |                          | 10,220         |
| Other borrowings   |                       | 2,737          |                          | 2,738          |
| Convertible bonds  |                       | 12,410         |                          | 12,577         |
| Redeemable preference shares                               |                       | 33,637         |                          | 12,312         |
|  |                       | <u>58,797</u>  |                          | <u>37,847</u>  |
|  | ₩                     | <u>139,932</u> | ₩                        | <u>123,809</u> |

Bank borrowings are collateralized with the Group's property, plant and equipment (Note 14).

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

*(in millions of Korean won)*

| <b>Currency</b>  | <b>Creditor</b>                              | <b>Latest maturity date</b> | <b>Annual interest rate(%)<br/>March 31, 2012</b> | <b>March 31, 2012</b> | <b>December 31, 2011</b> |
|------------------|--|-----------------------------|---|-----------------------|--------------------------|
| Korean won       | Kookmin Bank, other                          | Short-term Borrowings       | 3M CD rate+2.50                                   | ₩ 6,146               | ₩ 6,351                  |
| Korean won       | Citibank                                     | Short-term Borrowings       | CD(91)+1.25                                       | 28,561                | 28,829                   |
| Korean won       | Hana Bank, other                             | Short-term Borrowings       | 4.02 ~ 7.03                                       | 36,015                | 35,606                   |
| Foreign currency | BCA, other                                   | Short-term Borrowings       | 12.00   | 506                   | 4,235                    |
| Korean won       | National Agricultural Cooperative Federation | 2016. 07. 20                | 1.50  | 756                   | 756                      |
| Korean won       | Hana Bank                                    | 2013. 03. 15                | 2.00  | 280                   | 503                      |
| Korean won       | Hana Bank                                    | 2017. 03. 31                | 3.80  | 1,189                 | 1,036                    |
| Korean won       | Korea Development Bank                       | 2014. 11. 07                | 5.44  | 8,000                 | 8,474                    |
| Korean won       | Korea Development Bank                       | 2018. 06. 09                | 3.70  | 291                   | -                        |
|                  |  |                             |   | <u>₩ 81,744</u>       | <u>₩ 85,790</u>          |

**Convertible Bond**

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

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

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of income taxes.

Redeemable preference shares

- instrument over the life: 10 year from the date of issue
- ordinary shares conversion option: In instrument over the life can be converted 1,090,909 ordinary shares at any time, and automatically converts over the maturity.
- recourse option: if KT&G Life Sciences will be not listed by the end of 2015, recourse is available.
- instrument over the life: 5 year from the date of issue
- ordinary shares conversion option: In instrument over the life can be converted 94,079 ordinary shares at any time, and automatically converts over the maturity.
- recourse option: if Somang Cosmetics Co., Ltd. will be not listed by the end of 2016, recourse is available.

**24. Defined Benefit Liability**

The amounts recognized on the statements of income for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i> | <b>March 31,<br/>2012</b> | <b>March 31,<br/>2011</b> |
|------------------------------------|---------------------------|---------------------------|
| Defined benefit plans :            |                           |                           |
| Current service cost               | ₩ 9,481                   | ₩ 7,925                   |
| Interest expenses                  | 2,282                     | 1,985                     |
| Expected return on plan assets     | (1,602)                   | (1,451)                   |
|                                    | <u>10,161</u>             | <u>8,459</u>              |
| Defined contribution plans :       |                           |                           |
| Pension costs                      | 641                       | 349                       |
| Total                              | <u>₩ 10,802</u>           | <u>₩ 8,808</u>            |

Out of total expenses, ₩3,724 million (2011: ₩3,281 million) and ₩7,079 million (2011: ₩5,527 million) were included in 'cost of sales' and 'selling and administrative expenses', respectively.

Defined benefit liability recognized on the statements of financial position as of March 31, 2012 and December 31, 2011, is as follows:

| <i>(in millions of Korean won)</i>               | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--|-----------------------|-----------------------|
| Present value of defined benefit liability:      | ₩ 240,698             | ₩ 233,377             |
| Fair value of plan assets                        | (148,986)             | (150,295)             |
| Liability on the statement of financial position | <u>₩ 91,712</u>       | <u>₩ 83,082</u>       |

Defined benefit liability recognized on the statements of financial position as of March 31, 2012, includes deposit for employee retirement insurance and to contribution to National pension plan national pension plan. The Group's deposit for employee retirement insurance and contribution to National pension plan are ₩2,665 million and ₩243 million, respectively.

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**25. Classification of Operating Income**

(1) Material items of operating income and expense

Operating income is calculated as gross profit net of distribution costs, selling and administrative expenses, and other income and expenses.

(2) Distinctions between the previous K-GAAP and the Korean IFRS

Under the former accounting standards, operating income was calculated as gross profit net of distribution costs and selling and administrative expenses. Under the Korean IFRS, distribution costs, selling and administrative expenses, and other income and expenses. Therefore, the operating income amount under the previous K-GAAP differs from that under the Korean IFRS by the amount of the other operating income and expenses.

(3) Employee benefit costs for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|------------------------------------|-----------------------|-----------------------|
| Salaries                           | ₩ 115,088             | ₩ 105,014             |
| Retirement benefits                | 10,802                | 8,808                 |
| Termination benefits               | 1,194                 | -                     |
| Employee welfare                   | 11,827                | 11,203                |
|                                    | <u>₩ 138,911</u>      | <u>₩ 125,025</u>      |

(4) Depreciation and amortization for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i> | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|------------------------------------|-----------------------|-----------------------|
| Depreciation                       | ₩ 40,729              | ₩ 34,697              |
| Amortization                       | 2,591                 | 399                   |
|                                    | <u>₩ 43,320</u>       | <u>₩ 35,096</u>       |

(5) Details of other income for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i>                         | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--|-----------------------|-----------------------|
| Foreign currency transaction gain                          | ₩ 6,160               | ₩ 1,875               |
| Foreign currency translation gain                          | 3,759                 | 1,517                 |
| Reversal of impairment loss on trade and other receivables | 117                   | -                     |
| Gain on sale of property, plant and equipment              | 1,751                 | 5,228                 |
| Gain on sale of intangible assets                          | 311                   | 789                   |
| Others   | 4,588                 | 2,733                 |
|  | <u>₩ 16,686</u>       | <u>₩ 12,142</u>       |

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(6) Selling and administrative expenses for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i>  | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|-------------------------------------|-----------------------|-----------------------|
| Salaries                            | ₩ 74,773              | ₩ 66,701              |
| Retirement and termination benefits | 8,046                 | 5,527                 |
| Employee welfare                    | 7,814                 | 7,428                 |
| Travel                              | 3,202                 | 2,361                 |
| Communications                      | 1,486                 | 1,245                 |
| Utilities                           | 2,832                 | 2,491                 |
| Taxes and dues                      | 4,617                 | 4,046                 |
| Supplies                            | 1,024                 | 873                   |
| Rent                                | 7,303                 | 6,082                 |
| Depreciation                        | 12,150                | 9,129                 |
| Amortization                        | 2,550                 | 345                   |
| Repairs and maintenance             | 1,594                 | 1,609                 |
| Vehicles                            | 3,009                 | 2,314                 |
| Insurance                           | 800                   | 570                   |
| Commissions                         | 51,998                | 38,216                |
| Freight and custody                 | 9,164                 | 8,658                 |
| Conferences                         | 895                   | 785                   |
| Advertising                         | 61,668                | 52,369                |
| Training                            | 1,849                 | 1,706                 |
| Prizes and rewards                  | 459                   | 218                   |
| Cooperation                         | 394                   | -                     |
| Normal research and development     | 7,873                 | 5,167                 |
|                                     | <u>₩ 265,500</u>      | <u>₩ 217,840</u>      |

(7) Details of other expenses for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i>             | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--|-----------------------|-----------------------|
| Foreign currency transaction loss              | ₩ 7,652               | ₩ 4,662               |
| Foreign currency translation loss              | 11,446                | 13,140                |
| Impairment loss on trade and other receivables | 199                   | 132                   |
| Donations                                      | 2,623                 | 2,343                 |
| Loss on sale of property, plant and equipment  | 35                    | 101                   |
| Loss on sale of intangible assets              | 380                   | 126                   |
| Loss on retirement of inventories              | -                     | 688                   |
| Others   | 2,259                 | 1,359                 |
|  | <u>₩ 24,594</u>       | <u>₩ 22,551</u>       |

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**26. Expenses by Nature**

Expenses by nature for the three-month periods ended March 31, 2012 and 2011, are as follows:

*(in millions of Korean won)*

|   | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|---|-----------------------|-----------------------|
| Changes in inventories  | ₩ 91,689              | ₩ 82,137              |
| Raw materials and consumables used                                  | 239,843               | 44,878                |
| Salary and wage   | 116,282               | 105,014               |
| Retirement benefits   | 10,802                | 8,808                 |
| Depreciation charges  | 40,729                | 34,697                |
| Amortization charges  | 2,591                 | 399                   |
| Employee benefits   | 11,827                | 11,203                |
| Advertising costs   | 60,605                | 20,897                |
| Service fees  | 58,160                | 22,978                |
| Other expenses  | 87,602                | 256,180               |
| Total cost of sales, distribution costs and administrative expenses | ₩ 720,130             | ₩ 587,191             |

**27. Financial Income and Costs**

Financial income and costs for the three-month periods ended March 31, 2012 and 2011, are as follows:

*(in millions of Korean won)*

|  | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--|-----------------------|-----------------------|
| <b>Financial cost</b>                                      |                       |                       |
| Interest costs   | ₩ (3,929)             | ₩ (677)               |
| Loss on sale of available-for-sale financial assets        | (9)                   | -                     |
| Impairment loss on available-for-sale financial assets     | -                     | (3,988)               |
|  | <u>(3,938)</u>        | <u>(4,665)</u>        |
| <b>Financial income</b>                                    |                       |                       |
| Interest income  | 9,286                 | 8,855                 |
| Dividend income  | 3,416                 | 3,331                 |
| Investment income on long-term deposits in MSA Escrow Fund | 70                    | 302                   |
| Gain on sale of available-for-sale financial assets        | -                     | -                     |
|  | <u>12,772</u>         | <u>12,488</u>         |
| <b>Net financial income</b>                                | ₩ 8,834               | ₩ 7,823               |

Details of interest costs for the three-month periods ended March 31, 2012 and 2011, are as follows:

*(in millions of Korean won)*

|                          | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--------------------------|-----------------------|-----------------------|
| Borrowings               | ₩ (2,314)             | ₩ (660)               |
| Trade and other payables | (442)                 | (17)                  |
| Others                   | (1,173)               | -                     |
|                          | <u>₩ (3,929)</u>      | <u>₩ (677)</u>        |

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Details of interest income for the three-month periods ended March 31, 2012 and 2011, are as follows:

*(in millions of Korean won)*

|                                     | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|-------------------------------------|-----------------------|-----------------------|
| Deposits                            | ₩ 7,230               | ₩ 8,322               |
| Available-for-sale financial assets | 5                     | 12                    |
| Trade and other receivables         | 2,051                 | 521                   |
|                                     | <u>₩ 9,286</u>        | <u>₩ 8,855</u>        |

## **28. Income Tax**

Income tax expense was calculated based on the best weighted average annual tax rate of corporate for the entire fiscal period. Estimated average annual tax rate of the year ended December 31, 2012, is 30.5%. The estimated tax rate for the three-month period ended March 31, 2011, was 28.8%. The increase in corporate income tax rate is due to 2% increase of tax rate. The increase in corporate tax rate has been applied from January 1, 2012.

## **29. Earnings per Share**

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

Basic earnings per ordinary share for the three-month periods ended March 31, 2012 and 2011, is as follows:

|  | <b>March 31, 2012</b> | <b>March 31, 2011</b> |
|--|-----------------------|-----------------------|
| Profit attributable to owners of the Parent Company    | ₩ 190,820 million     | ₩ 182,398 million     |
| Weighted-average number of ordinary shares outstanding | 127,648,800           | 127,648,800           |
| <b>Basic and diluted earnings per share in won</b>     | <u>₩ 1,517</u>        | <u>₩ 1,429</u>        |

## **30. Dividends**

The dividends paid in 2012 and 2011 were ₩402,396 million and ₩382,946 million, respectively.

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**31. Cash Generated from Operations**

- (1) Cash generated from operations for the three-month periods ended March 31, 2012 and 2011, are as follows:

| <i>(in millions of Korean won)</i>                         | <b>March 31, 2012</b> |                | <b>March 31, 2011</b> |                |
|--|-----------------------|----------------|-----------------------|----------------|
| <b>Profit</b>  | ₩                     | 186,254        | ₩                     | 183,113        |
| Adjustments for:   |                       |                |                       |                |
| Income tax expense   |                       | 81,819         |                       | 74,242         |
| Finance costs  |                       | 3,939          |                       | 4,666          |
| Finance income   |                       | (12,772)       |                       | (12,488)       |
| Depreciation   |                       | 40,729         |                       | 34,697         |
| Amortization   |                       | 2,591          |                       | 399            |
| Retirement and termination benefits                        |                       | 11,891         |                       | 8,808          |
| Foreign currency translations loss                         |                       | 11,446         |                       | 13,140         |
| Loss on the write-down of inventories                      |                       | 350            |                       | 589            |
| Impairment loss on trade and other receivables             |                       | 199            |                       | 132            |
| Loss on sale of property, plant and equipment              |                       | 35             |                       | 101            |
| Loss on sale of intangible assets                          |                       | 380            |                       | 126            |
| Other expense  |                       | 62             |                       | 701            |
| Share of gain of associates                                |                       | (1,286)        |                       | (273)          |
| Share of loss of associates                                |                       | 165            |                       | 136            |
| Foreign currency translations gain                         |                       | (3,759)        |                       | (1,517)        |
| Reversal of impairment loss on trade and other receivables |                       | (117)          |                       | -              |
| Gain on sale of property, plant and equipment              |                       | (1,751)        |                       | (5,228)        |
| Gain on sale of intangible assets                          |                       | (311)          |                       | (789)          |
|  |                       | <u>319,864</u> |                       | <u>300,555</u> |
| <b>Changes in working capital:</b>                         |                       |                |                       |                |
| Trade and other receivables                                |                       | (39,795)       |                       | 21,228         |
| Advance payments   |                       | (53,690)       |                       | (41,643)       |
| Prepaid expenses   |                       | (2,838)        |                       | (1,868)        |
| Prepaid tobacco excise and other taxes                     |                       | (20,477)       |                       | (45,728)       |
| Inventories  |                       | 86,936         |                       | 82,135         |
| Trade and other payables                                   |                       | (24,599)       |                       | (48,365)       |
| Advance receipts   |                       | 20,159         |                       | 1,447          |
| Tobacco excise and other taxes payable                     |                       | 310,595        |                       | 127            |
| Payment of retirement benefits                             |                       | (3,492)        |                       | (3,845)        |
| <b>Cash generated from operations</b>                      | ₩                     | <u>592,663</u> | ₩                     | <u>264,043</u> |

- (2) Non-cash transactions

| <i>(in millions of Korean won)</i>  | <b>March 31, 2012</b> |        |
|---|-----------------------|--------|
| Reclassification of property, plant and equipment to non-current assets held for sale | ₩                     | 10,753 |
| Reclassification of investment property to property, plant and equipment              |                       | 4,864  |
| Reclassification of construction-in-progress to property, plant and equipment         |                       | 10,534 |

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**32. Contingencies**

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

As of March 31, 2012, tobacco lawsuits claiming damages of ₩ 584 million are filed against the Group and the Korean government. The amount of the liability the Group may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of March 31, 2012.

As of March 31, 2012, the Group has letter of credit agreements with Korea Exchange Bank and other banks with limits in the aggregate of USD 47,500 thousand.

As of March 31, 2012, the Group's trade receivables from the export of cigarettes are insured against non-payment up to USD 36,300 thousand by an export guarantee insurance with the Korea Export Insurance Corporation.

As of March 31, 2012, the Group 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.

The Group has maintained a contract with the farmers who grow six-year old green ginseng for purchase volume guarantees and recorded contractual amounts paid to the farmers as advance payments in the amount of ₩ 236,387 million (non-current: ₩ 139,190 million; current: ₩ 97,197 million) as of March 31, 2012.

As of March 31, 2012, the Group has an accounts receivable loan agreement with a limit of ₩ 85,000 million with Hana Bank and other financial institutions.

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

As of March 31, 2012, the Group has a loan agreement with a limit of ₩ 95,409 million with Shinhan Bank and other financial institutions.

As of March 31, 2012, the Group has provided two blank notes, 13 notes amounting to ₩ 14,200 million and five blank checks to Resolution and Finance Corporation and others as collateral for its borrowings and trade agreements. As of March 31, 2012, lost a note provided as collateral is in the process of nullification.

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

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

Relative to the acquisition of Somang Cosmetics Co., Ltd., the Parent Company entered into a



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contract with a former owner of the acquiree, Kang Seok-Chang ("Individual Shareholder"). Details of the contract are as follows:

1) Conditional put option granted to Individual Shareholder

The Parent Company shall be required to purchase Individual Shareholder's shares, in whole or in part, at the agreed price if the following conditions are met:

- Somang Cosmetics Co., Ltd. satisfies all the listing requirements.
- Notwithstanding the written request of Individual Shareholder, Somang Cosmetics Co., Ltd. is not able to undertake the necessary procedures for listing, due to the Parent Company's objection, within three years after the Parent Company acquired Somang Cosmetics Co., Ltd.

2) Right of first refusal held by the Parent 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 Parent Company.

3) Tag-along right held by Individual Shareholder

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

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

1) Restriction of disposal

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

2) Right of first refusal held by the Parent Company

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 Parent Company.

3) Tag-along right held by Individual Shareholder

In the event that the Parent Company proposes to enter into a transaction or a series of related transactions with a third party purchaser to dispose of 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 Parent Company.

As of March 31, 2012, the Group has letter of credit agreements with Korea Exchange Bank with limits in the aggregate of USD 2,500 thousand.

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**33. Related Parties**

The Group has no significant transactions and receivables, liabilities with related parties, for the three-month period ended March 31, 2012.

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

*(in millions of Korean won)*

| Guarantor       | Guarantee for              | Purpose           | March 31, 2012 |                 | December 31, 2011 |                 |
|-----------------|----------------------------|-------------------|----------------|-----------------|-------------------|-----------------|
|                 |                            |                   | Limitation     | Exercise amount | Limitation        | Exercise amount |
| Kang Seok-chang | Somang Cosmetics Co., Ltd. | Application funds | ₩ 33,012       | ₩ 24,194        | ₩ 21,175          | ₩ 16,748        |

The compensation paid or payable to key management for employee services for the three-month periods ended March 31, 2012 and 2011, consists of:

*(in millions of Korean won)*

|                              | March 31, 2012 |       | March 31, 2011 |       |
|------------------------------|----------------|-------|----------------|-------|
| Short-term employee benefits | ₩              | 5,995 | ₩              | 4,594 |
| Retirement benefits          |                | 1,151 |                | 425   |
|                              | ₩              | 7,146 | ₩              | 5,019 |

**34. Basis of Translating Financial Statements**

The financial statements are expressed in Korean won and have been translated into U.S. dollars at the rate of ₩ 1,137.80 to \$1, the basic exchange rate on March 31, 2012, posted by Seoul Money Brokerage Services, solely for the convenience of the reader. This translation should not be construed as a representation that any or all of the amounts shown could be converted into U.S. dollars at this or any other rate.