

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Financial Statements

(Unaudited)

March 31, 2007 and 2006

(With Independent Accountants' Review Report Thereon)

Independent Accountants' Report

Based on a report originally issued in Korean

The Board of Directors and Stockholders
KT&G Corporation:

We have reviewed the accompanying consolidated balance sheets of KT&G Corporation and subsidiaries (collectively, the "Company") as of March 31, 2007, and the related consolidated statements of income, cash flows and changes in stockholders' equity for the three-month periods ended March 31, 2007 and 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these consolidated financial statements based on our reviews. We were furnished with the report of other reviewers on their review of the financial information of Yungjin Pharm. Ind. Co., Ltd., whose total assets as of March 31, 2007 and whose revenues for the three-month period then ended constituted 3.1% and 4.7%, respectively, of the related consolidated totals.

We conducted our reviews in accordance with the Review Standards for Semiannual Financial Statements established by the Securities and Futures Commission of the Republic of Korea. These standards require that we plan and perform the review to obtain moderate assurance as to whether the consolidated financial statements are free of material misstatement. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data and, thus, provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our reviews and the report of the other reviewers, nothing has come to our attention that causes us to believe that the consolidated financial statements referred to above are not presented fairly, in all material respects, in accordance with accounting principles generally accepted in the Republic of Korea.

The consolidated balance sheet of the Company as of December 31, 2006 and the related consolidated statements of income, changes in stockholders' equity and cash flows for the year then ended, which are not accompanying this report, were audited by us and our report thereon, dated February 28, 2007, expressed an unqualified opinion on those statements. The accompanying consolidated balance sheet of the Company as of December 31, 2006, presented for comparative purposes, is not different from that audited by us in all material respects.

The accompanying consolidated financial statements as of and for the three-month period ended March 31, 2007 have been translated into United States dollars solely for the convenience of the reader. We have reviewed the translation and, in our opinion, the consolidated financial statements expressed in Korean Won have been translated into United States dollars on the basis set forth in note 2 to the consolidated financial statements.

The following matters may be helpful to the readers in their understanding of the consolidated financial statements:

As discussed in note 1(b) to the consolidated financial statements, accounting principles and review standards and their application in practice vary among countries. The accompanying consolidated financial statements are not intended to present the financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries other than the Republic of Korea. In addition, the procedures and practices utilized in the Republic of Korea to review such consolidated financial statements may differ from those generally accepted and applied in other countries. Accordingly, this report and the accompanying consolidated financial statements are for use by those knowledgeable about Korean accounting procedures and review standards and their application in practice.

As discussed in note 25 to the consolidated financial statements, the Company has entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund with the target set at ₩410,000 million by 2008 for the purpose of stabilizing tobacco production. Under the agreement, the Company is obligated to make up the deficiency, should the fund fall short of the target. The Company estimates the deficiency at the end of each period and provides for a provision to fully fund the tobacco production stabilization program by 2008. The provision for the fund made by the Company amounted to ₩4,301 million and ₩4,521 million for the three-month periods ended March 31, 2007 and 2006, respectively, and the reserve for the fund as of March 31, 2007 and December 31, 2006 amounted to ₩78,785 million and ₩74,484 million, respectively.

As discussed in note 24 to the consolidated financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩1,282 million for the effects of smoking. According to the Company's management, the final outcome of these lawsuits cannot be predicted at present. Accordingly, no provisions have been made in the accompanying consolidated financial statements.

As discussed in notes 11 and 24 to the consolidated financial statements, the Company maintains a contract with the farmers under which they are to grow green ginseng and, once the product becomes six years old, sell the ginseng to the Company. As of March 31, 2007 and December 31, 2006, the balance of advance payments paid to the farmers in accordance with the contract amounted to ₩140,286 million and ₩107,848 million, respectively.

Seoul, Korea
May 4, 2007

This report is effective as of May 4, 2007, 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 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 circumstances, if any.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

March 31, 2007 and December 31, 2006

(In millions of Korean Won and thousands of United States dollars)

Assets	(Unaudited)		(Audited)
	March 31, 2007		December 31,
	Korean Won	U.S. dollars (note 2)	2006 Korean Won
Current assets:			
Cash and cash equivalents (note 20)	₩ 746,446	\$ 793,838	₩ 201,869
Short-term financial instruments	81,000	86,143	1,000
Trade accounts receivable, net of allowance for doubtful accounts of ₩15,567 in 2007 and ₩39,306 in 2006 (notes 4, 9, 20 and 24)	317,269	337,411	355,029
Inventories (notes 5 and 14)	1,208,079	1,284,779	1,299,769
Current portion of long-term loans, net of allowance for doubtful accounts of ₩1,032 in 2007 and ₩1,000 in 2006 and present value discount of ₩8,258 in 2007 and ₩11,416 in 2006 (note 10)	102,773	109,298	99,647
Current portion of deferred income tax assets (note 27)	9,068	9,644	8,226
Other current assets (note 6)	<u>157,887</u>	<u>167,913</u>	<u>83,405</u>
Total current assets	2,622,522	2,789,026	2,048,945
Available-for-sale securities (note 7)	77,731	82,666	71,156
Equity method investment securities (note 8)	1,386	1,474	1,111
Long-term loans	1,966	2,091	2,014
Long-term loans to employees	72,472	77,073	61,408
Long-term loans to affiliates (note 9)	1,521	1,618	1,487
Guarantee deposits	42,785	45,501	42,510
Guarantee deposits for membership	21,502	22,868	21,502
Long-term deposit in Escrow Fund (notes 20 and 24)	54,187	57,628	45,611
Other investment assets, net of allowance for doubtful accounts of ₩2,912 in 2007 and ₩1,507 in 2006	6,988	7,431	5,716
Property, plant and equipment, at cost (notes 12, 13 and 14)	2,263,909	2,407,646	2,239,932
Less accumulated depreciation and impairment	<u>(808,494)</u>	<u>(859,826)</u>	<u>(777,188)</u>
Net property, plant and equipment	1,455,415	1,547,820	1,462,744
Intangible assets	11,334	12,054	12,248
Other assets (note 15)	<u>83,237</u>	<u>88,522</u>	<u>80,674</u>
Total assets	₩ <u>4,453,046</u>	\$ <u>4,735,772</u>	₩ <u>3,857,126</u>

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets, Continued

March 31, 2007 and December 31, 2006

(In millions of Korean Won and thousands of United States dollars, except share data)

<u>Liabilities and Stockholders' Equity</u>	(Unaudited) March 31, 2007		(Audited)
	Korean Won	U.S. dollars (note 2)	December 31, 2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Current liabilities:			
Trade accounts payable (notes 9 and 20)	₩ 27,059	\$ 28,777	₩ 14,896
Short-term borrowings (notes 17, 20 and 24)	93,618	99,562	80,786
Advance receipts	17,645	18,765	7,999
Value added tax payable	129,982	138,235	128,948
Accrued expenses	13,167	14,003	10,519
Other payables	143,659	152,780	30,548
Tobacco excise tax and other	413,640	439,902	55,388
Income taxes payable	70,526	75,004	135,654
Dividends payable	319,712	340,011	-
Other current liabilities (note 16)	25,463	27,079	18,383
Total current liabilities	1,254,471	1,334,118	483,121
Long-term borrowings (notes 18 and 24)	1,402	1,491	1,402
Retirement and severance benefits (note 19)	90,222	95,950	99,506
Guarantee deposits received	25,816	27,455	27,525
Deferred income tax liabilities (note 27)	115,069	122,375	103,528
Reserve for sales returns	1,570	1,670	1,797
Reserve for Tobacco Production Stabilization Fund (note 25)	78,785	83,787	74,484
Total liabilities	1,567,335	1,666,846	791,363
Stockholders' equity			
Common stock of ₩5,000 par value (note 1):			
Authorized – 800,000,000 shares			
Issued – 147,442,497 shares			
Outstanding – 133,371,548 shares in 2007 and 133,213,315 shares in 2006	954,959	1,015,590	954,959
Capital surplus	339,956	361,540	335,350
Capital adjustments (note 21)	(318,573)	(338,800)	(321,904)
Accumulated other comprehensive income (note 22)	19,093	20,305	15,791
Retained earnings (note 23)	1,871,053	1,989,847	2,061,349
Minority interest in consolidated subsidiaries	19,223	20,444	20,218
Total stockholders' equity	2,885,711	3,068,926	3,065,763
Commitments and contingencies (note 24)			
Total liabilities and stockholders' equity	₩ 4,453,046	\$ 4,735,772	₩ 3,857,126

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income

Three-month periods ended March 31, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousands of United States dollars, except earnings per share)

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Sales (notes 9, 26 and 33)	₩ 663,814	\$ 705,960	₩ 576,233
Cost of sales (notes 9, 26, 30 and 31)	<u>297,145</u>	<u>316,009</u>	<u>271,912</u>
Gross profit	366,669	389,951	304,321
Selling and administrative expenses (notes 30, 31 and 32)	<u>169,644</u>	<u>180,415</u>	<u>153,864</u>
Operating income	<u>197,025</u>	<u>209,536</u>	<u>150,457</u>
Other income (expense):			
Interest income	10,406	11,066	10,100
Interest expense	(1,220)	(1,298)	(820)
Gain (loss) on foreign currency transactions, net	1,227	1,304	(4,054)
Other bad debts expense	(364)	(387)	(10)
Loss on impairment of available-for-sale securities	-	-	(1,601)
Gain on valuation of equity method investment securities	275	293	137
Loss on valuation of equity method investment securities	-	-	(1,878)
Gain (loss) on sales of property, plant and equipment, net	3,511	3,735	(571)
Gain on conversion of convertible bonds	-	-	1,876
Donations	(6,470)	(6,881)	(12,497)
Provision for Tobacco Production Stabilization Fund (note 25)	(4,301)	(4,574)	(4,521)
Other, net	<u>(6,504)</u>	<u>(6,919)</u>	<u>1,133</u>
	<u>(3,440)</u>	<u>(3,661)</u>	<u>(12,706)</u>
Income before income taxes and minority interest	193,585	205,875	137,751
Income taxes (note 27)	<u>64,994</u>	<u>69,120</u>	<u>41,618</u>
Income before minority interest	128,591	136,755	96,133
Minority interest in losses of consolidated subsidiaries	<u>(922)</u>	<u>(981)</u>	<u>(623)</u>
Net income	₩ <u>129,513</u>	\$ <u>137,736</u>	₩ <u>96,756</u>
Basic earnings per share in Korean Won and U.S. dollars (note 28)	₩ <u>972</u>	\$ <u>1.03</u>	₩ <u>666</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Changes in Stockholders' Equity

Three-month periods ended March 31, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousands of United States dollars)

	Korean Won							U.S. dollars (note 2)
	Common stock	Capital surplus	Capital adjustments	Accumulated other Comprehensive income	Retained earnings	Minority interest	Total	
Balance at January 1, 2006	₩ 954,959	299,979	(349,885)	22,939	2,519,737	23,136	3,470,865	
Dividends	-	-	-	-	(249,703)	-	(249,703)	
Unappropriated retained earnings	-	-	-	-	2,270,034	-	3,221,162	
Net income	-	-	-	-	96,756	-	96,756	
Minority interest in losses of consolidated subsidiaries	-	-	-	-	-	(623)	(623)	
Unrealized loss on valuation of available-for-sale securities	-	-	-	(6,425)	-	-	(6,425)	
Unrealized loss on valuation of equity method investments	-	-	-	(145)	-	-	(145)	
Reacquisition of treasury stock	-	-	(160,819)	-	-	-	(160,819)	
Retirement of treasury stock	-	-	160,819	-	(160,819)	-	-	
Changes in translation adjustments	-	-	-	(177)	-	-	(177)	
Other	-	-	-	-	163	20	183	
Balance at March 31, 2006	₩ 954,959	299,979	(349,885)	16,192	2,206,134	22,533	3,149,912	
Balance at January 1, 2007	₩ 954,959	335,350	(321,904)	15,791	2,061,349	20,218	3,065,763	\$ 3,260,409
Dividends	-	-	-	-	(319,712)	-	(319,712)	(340,011)
Unappropriated retained earnings	-	-	-	-	1,741,637	-	2,746,051	2,920,398
Net income	-	-	-	-	129,513	-	129,513	137,736
Minority interest in losses of consolidated subsidiaries	-	-	-	-	-	(922)	(922)	(981)
Unrealized gain on valuation of available-for-sale securities	-	-	-	3,107	-	-	3,107	3,304
Unrealized loss on valuation of equity method investments	-	-	-	(254)	-	-	(254)	(270)
Compensation by treasury stock	-	4,606	3,331	-	-	-	7,937	8,441
Changes in translation adjustments	-	-	-	449	-	-	449	478
Change of consolidated subsidiaries	-	-	-	-	(97)	(73)	(170)	(180)
Balance at March 31, 2007	₩ 954,959	339,956	(318,573)	19,093	1,871,053	19,223	2,885,711	\$ 3,068,926

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Three-month periods ended March 31, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousands of United States dollars)

	2007		2006	
	Korean Won	U.S. dollars (note 2)	Korean Won	
Cash flows from operating activities:				
Net income	₩ 129,513	\$ 137,736	₩ 96,756	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	37,720	40,116	32,632	
Loss on valuation of inventories, net	9,783	10,404	9,152	
Loss on impairment of available-for-sale securities	-	-	1,601	
Gain on valuation of equity method investment securities	(275)	(293)	(137)	
Loss on valuation of equity method investment securities	-	-	1,878	
Loss (gain) on foreign currency transactions, net	(566)	(602)	1,501	
Provision for retirement and severance benefits	3,068	3,263	4,906	
Loss (gain) on sale of property, plant and equipment, net	(3,511)	(3,735)	571	
Amortization of present value discounts	(3,180)	(3,382)	(2,815)	
Provision for Tobacco Production Stabilization Fund	4,301	4,574	4,521	
Gain on conversion of convertible bonds	-	-	(1,876)	
Deferred income taxes, net	9,485	10,087	483	
Minority interest in losses of consolidated subsidiaries	(922)	(981)	(623)	
Decrease (increase) in assets:				
Trade accounts receivable	40,817	43,408	50,762	
Other receivables	(16,210)	(17,240)	(4,385)	
Accrued income	(2,557)	(2,719)	947	
Advance payments	(31,441)	(33,437)	(26,112)	
Prepaid expenses	(29,885)	(31,783)	(24,577)	
Inventories	82,310	87,536	73,917	
Long-term advance payments	(16)	(17)	(111)	
Increase (decrease) in liabilities:				
Trade accounts payable	4,222	4,490	(16,454)	
Other payables	112,314	119,444	3,174	
Advance receipts	9,647	10,259	8,321	
Withholdings	8,254	8,778	762	
Value added tax payable	1,034	1,100	(34,216)	
Accrued expenses	9,193	9,777	6,091	
Tobacco excise tax and dues payable	358,252	380,998	101,818	
Income taxes payable	(66,875)	(71,121)	9,832	
Unearned income	(520)	(553)	(792)	
Payments of retirement and severance benefits	(8,554)	(9,097)	(1,574)	
Increase in deposit for severance benefit trust	2,615	2,781	(543)	
Other, net	3,551	3,776	(168)	
Net cash provided by operating activities	661,567	703,567	295,242	

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows, Continued

Three-month periods ended March 31, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousands of United States dollars)

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from investing activities:			
Proceeds from sale of available-for-sale securities	127	135	5,056
Proceeds from sale of property, plant and equipment	9,855	10,481	530
Decrease in guarantee deposits	968	1,030	4,505
Increase in short-term financial instruments	(80,000)	(85,079)	(39,000)
Purchases of available-for-sale securities	(1,182)	(1,257)	(3,500)
Purchases of property, plant and equipment	(35,617)	(37,878)	(39,964)
Purchases of intangible assets	(194)	(207)	(214)
Increase in guarantee deposits	(978)	(1,041)	(829)
Increase in long-term deposits in the Escrow Fund	(8,051)	(8,563)	(3,551)
Decrease (increase) in long-term loans to employees	(11,066)	(11,768)	4,147
Other, net	(1,266)	(1,347)	(126)
Net cash used in investing activities	(127,404)	(135,494)	(72,946)
Cash flows from financing activities (note 29):			
Decrease in guarantee deposits received, net	(1,923)	(2,045)	(585)
Proceeds from short-term borrowings	12,812	13,625	52,114
Proceeds from long-term borrowings	-	-	105
Reacquisition of treasury stock	-	-	(160,819)
Repayment of short-term borrowings	-	-	(44,377)
Repayment of long-term borrowings	-	-	(2)
Net cash provided by (used in) financing activities	10,889	11,580	(153,564)
Net increase in cash and cash equivalents from change of subsidiaries in consolidated financial statements	(888)	(942)	4,531
Increase in cash and cash equivalents due to merger	413	441	-
Net increase in cash and cash equivalents	544,577	579,152	73,263
Cash and cash equivalents at beginning of period	201,869	214,686	348,909
Cash and cash equivalents at end of period	₩ 746,446	\$ 793,838	₩ 422,172

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

March 31, 2007 and December 31, 2006

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements

(a) Description of Business

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

As of March 31, 2007, KT&G has four manufacturing plants, including the Shin Tan Jin plant, and 14 local headquarters and 168 branches for the sale of tobacco throughout the country. Also KT&G has two plants for fabrication of leaf tobacco, including the Nam Won plant, and the Chun Ahn printing plant for the manufacturing of wrapping paper.

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

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

The ownership of the Company's issued common stock at March 31, 2007 is held as follows:

<u>Stockholder</u>	<u>Number of shares</u>	<u>Percentage of ownership</u>
Industrial Bank of Korea	9,510,485	6.45%
Employee Stock Ownership Association	8,493,632	5.76%
Treasury stock	14,070,949	9.54%
Others	<u>115,367,431</u>	<u>78.25%</u>
	<u>147,442,497</u>	<u>100.00%</u>

The Company has, thus far, reacquired and retired 43,549,400 shares of treasury stock. Accordingly, as of March 31, 2007, the Company's common stock differs from the aggregate par value of issued shares by ₩217,747.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued(b) Basis of Presenting Consolidated Financial Statements

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

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

Effective January 1, 2007, the Company adopted Statements of Korea Accounting Standards ("SKAS") No. 21 (*Preparation and Presentation of Financial Statements*), No. 22 (*Share-based Payment*), and No. 23 (*Earnings per Share*). The adoption of these standards did not have a significant impact on the accompanying consolidated financial statements. Certain accounts of prior year's consolidated financial statements have been reclassified to conform to the current year's presentation. These reclassifications have not resulted in any change to reported net income or stockholders' equity.

- (i) The consolidated financial statements include the accounts of KT&G and the following controlled subsidiaries (hereinafter referred to collectively as the "Company") as of March 31, 2007. Controlled subsidiaries include entities majority-owned by either the Company or a controlled subsidiary and other entities where the Company or its controlled subsidiary owns more than 30% of total outstanding common stock and is the largest shareholder. All significant intercompany balances and transactions have been eliminated in consolidation.

Subsidiary	Year of establishment	Number of shares	Percentage of ownership	Primary business
Korea Ginseng Corporation ("KGC")	1999	12,985,851	100.00%	Manufacturing ginseng products
Korea Ginseng (HK) Limited ("KGHK") (*1)	1999	18,866,999	99.99%	Sales of ginseng products in Hong Kong
Yungjin Pharm. Ind. Co., Ltd. ("YJPI")	1962	53,148,564	56.97%	Manufacturing pharmaceutical products
Tae-a Industry Co., Ltd. ("TAI") (*2)	1972	150,000	100.00%	Manufacturing subsidiary material for tobacco

(*1) The ownership percentage in KGHK represents the ownership of this entity by KGC.

(*2) The financial statements of KGHK and TAI included in consolidation were not reviewed by independent accountants.

(*3) Since KT&G USA, Inc. is currently in process of liquidation, KT&G USA, Inc.'s securities are excluded from consolidation in 2007.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued(b) Basis of Presenting Consolidated Financial Statements, Continued

- (ii) Significant account balances which occurred in the normal course of business with and between subsidiaries as of March 31, 2007 and December 31, 2006 are summarized as follows (these amounts have been eliminated in consolidation):

<u>Transaction Party</u>		<u>Balance Sheet Item</u>	<u>March 31, 2007</u>	<u>December 31, 2006</u>
KT&G	KGC	Other receivables	₩ 23,546	-
KT&G	TAI	Trade accounts payable	1,065	-
KT&G	KT&G USA	Trade accounts receivable	-	9,192
KGC	KT&G	Trade accounts receivable	21	13
KGC	KT&G	Guarantee deposits	2,152	2,323
KGC	KT&G	Prepaid expense	263	497
KGC	KGHK	Trade accounts receivable	426	7,863
KGC	YJPI	Trade accounts receivable	-	78

- (iii) Significant transactions which occurred in the normal course of business with and between consolidated subsidiaries for the three-month periods ended March 31, 2007 and 2006 are summarized as follows (these amounts have been eliminated in consolidation):

<u>Transaction Party</u>		<u>Income Statement Item</u>	<u>2007</u>	<u>2006</u>
KT&G	KGC	Sales	₩ 232	294
KT&G	YJPI	Sales	20	20
KT&G	KT&G USA	Sales	-	2,351
KT&G	KGC	Other income	3,449	2,256
KT&G	YJPI	Other income	1	19
KGC	KT&G	Sales	401	536
KGC	YJPI	Sales	215	-
KGC	KGHK	Sales	426	1,045
KGC	TAI	Sales	8	2
YJPI	KT&G	Sales	27	2
TAI	KT&G	Sales	2,951	2,577

- (iv) As of March 31, 2007, KGC has provided guarantees for KGHK within the limit of USD20,000 on short-term borrowings amounting to USD10,410.

(c) Cash Equivalents

The Company considers short-term financial instruments with maturities of three-month or less at the acquisition date to be cash equivalents.

(d) Financial Instruments

Short-term financial instruments are instruments handled by financial institutions which are held for short-term cash management purposes, maturing within one year. Such investments may include time deposits, installment savings deposits and restricted bank deposits.

(e) Allowance for Doubtful Accounts

Allowance for doubtful accounts is estimated based on an analysis of individual accounts and past experience of collection.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued

(f) Inventories

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-process; using the moving-average method for raw materials and supplies; and using the specific identification method for goods-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. The amount of any write-down of inventories to net realizable value due to obsolescence or excess inventory and other losses of inventories occurring in the normal course of business are recognized as cost of goods sold and such valuation losses are deducted from the inventories as allowance for valuation losses. The Company has recognized loss and reversal of loss on valuation of inventories amounting to ₩19,950 and ₩10,167, respectively, for the three-month period ended March 31, 2007. Also, the estimated amounts of inventories in current assets which are not expected to be realized within a year are ₩350,036 and ₩411,239, respectively, as of March 31, 2007 and December 31, 2006.

The Company recognizes interest costs and other financial charges on borrowings associated with inventories that require a long period in the acquisition, construction or production as an expense in the period in which they are incurred.

The Company did not make a count of the physical inventory as of March 31, 2007.

(g) Investment in Securities

Upon acquisition, the Company classifies certain debt and equity securities into one of the three categories: held-to-maturity, available-for-sale, or trading securities and such determination is reassessed at each balance sheet date. Investments in debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) are classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used to generate profit on short-term differences in price. Investments not classified as either held-to-maturity or trading securities are classified as available-for-sale securities.

Trading securities are carried at fair value, with unrealized holding gains and losses included in current income. Available-for-sale securities are carried at fair value, with unrealized holding gains and losses reported as a capital adjustment, net of tax. Investments in equity securities that do not have readily determinable fair values are stated at cost. Investments in debt securities that are classified into held-to-maturity are reported at amortized cost at the balance sheet date and such amortization is included in interest income.

The fair value of marketable securities is determined using quoted market prices as of the period end. Non-marketable debt securities are recorded at the fair values derived from the discounted cash flows by using an interest rate deemed to approximate the market interest rate. The market interest rate is determined by the issuers' credit rate announced by the accredited credit rating agencies in Korea. Money market funds are recorded at the fair value determined by the investment management companies.

Trading securities are classified as current assets, whereas available-for-sale securities and held-to-maturity securities are classified as long-term investments. However, available-for-sale securities whose maturity dates are due within one year from the balance sheet date or whose likelihood of being disposed of within one year from the balance sheet date is probable are classified as current assets. Likewise, held-to-maturity securities whose maturity dates are due within one year from the balance sheet date are classified as current assets.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued

(h) Investment Securities under the Equity Method

Investments in affiliated companies of which the Company owns 20% or more of the voting stock or over which the Company has significant management control are stated at an amount as determined using the equity method. Under the equity method of accounting, the Company's initial investment is recognized at cost and is subsequently increased or decreased to reflect the changes in Company's share of the net assets of investee. The Company's share of the profit or loss of the investee is recognized in the Company's profit or loss and other changes in the investee's equity are recognized directly in the corresponding equity account of the Company. If the Company holds other investments such as preferred stock or loans issued by the investee, the Company's share of loss of the investee continues to be recorded until such other investments are reduced to zero.

Any excess in the Company's acquisition cost over the Company's share of the net fair value of the investee's identifiable net assets is considered as goodwill and amortized by the straight-line method over the estimated useful life. The amortization of such goodwill is recorded against the equity in income (losses) of affiliates. When events or circumstances indicate that carrying amount may not be recoverable, the Company reviews goodwill for any impairment.

Assets and liabilities of foreign-based companies accounted for using the equity method are translated at current rate of exchange at the balance sheet date while profit and loss items in the statement of income are translated at average rate and capital account at historical rate. The translation gains and losses arising from collective translation of the foreign currency financial statements of foreign-based companies are offset and the balance is accumulated as comprehensive income.

Under the equity method of accounting, unrealized gains and losses on transactions with an investee are eliminated to the extent of the investor's interest in the investee. However, unrealized gains and losses from a down-stream transaction with a subsidiary are eliminated entirely.

Investments in affiliated companies are reduced when dividends are declared by shareholders' meeting of the respective affiliated companies.

(i) Property, Plant and Equipment

Property, plant and equipment are stated at cost, except in the case of revaluation made in accordance with the old Asset Revaluation Law. However, assets acquired through investment in kind or donation are recorded at their fair value upon acquisition.

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

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

	<u>Depreciation method</u>	<u>Useful lives (years)</u>
Buildings	Straight-line method	10 to 60
Structures	Straight-line method	10 to 40
Machinery and equipment	Straight-line or declining-balance method	2 to 18
Vehicles and other transportation equipment	Straight-line or declining-balance method	4 to 5
Tools	Straight-line or declining-balance method	4 to 5
Furniture and fixtures	Straight-line or declining-balance method	4 to 5

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued

(i) Property, Plant and Equipment, Continued

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

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

(j) Goodwill

Goodwill, which represents the excess of the acquisition cost over the fair value of net identifiable assets acquired, is amortized on a straight-line basis over the expected periods to be benefited but generally less than 20 years. In cases where goodwill is no longer probable of being recovered from the expected future economic benefit, it is expensed immediately.

(k) Intangible Assets

Intangible assets are stated at cost less accumulated amortization, as described below.

(i) Research and Development Costs

To assess whether an internally generated intangible asset meets the recognition criteria, the Company classifies the generation process into a research phase and a development phase. All costs incurred during the research phase shall be expensed as incurred. Costs incurred during the development phase shall be recognized as assets only if they satisfy all criteria for recognition. An intangible asset shall be recognized only if (1) it is probable that future economic benefits that are attributable to the asset will flow into the entity and (2) the cost of the asset can be measured reliably. If the costs incurred fail to satisfy all of these criteria, they shall be recorded as periodic expenses as incurred.

(ii) Other Intangible Assets

Other intangible assets, which consist of industrial property rights and other, are stated at cost less accumulated amortization and impairment losses. Such intangible assets are amortized using the straight-line method over a reasonable period based on the nature of the asset.

The Company reviews for the impairment of intangible assets, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued

(l) Valuation of Receivables and Payables at Present Value

Receivables and payables arising from long-term cash loans/borrowings and other similar transactions are stated at present value. The difference between the nominal value and present value of related receivables or payables is amortized using the effective interest method. The amount amortized is included in interest expense or interest income.

(m) Retirement and Severance Benefits

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

Through March 1999, under the National Pension Scheme of Korea, the Company transferred a certain portion of retirement allowances for employees to the National Pension Fund. The amount transferred will reduce the retirement and severance benefit amount to be payable to the employees when they leave the Company and is accordingly reflected in the accompanying consolidated financial statements as a reduction of the retirement and severance benefits liability. However, due to the new regulation effective April 1999, such transfers to the National Pension Fund are no longer required.

(n) Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at the balance sheet date, with the resulting gains or losses recognized in current results of operations. Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at ₩940.30 to USD1, the rate of exchange on March 31, 2007 that is permitted by the Financial Accounting Standards. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Korean Won at the foreign exchange rate on the date of the transaction.

Foreign currency assets and liabilities of foreign-based operations and companies accounted for using the equity method are translated at current rate of exchange at the balance sheet date while profit and loss items in the statement of income are translated at average rate and capital account at historical rate. The translation gains and losses arising from collective translation of the foreign currency financial statements of foreign-based operations are accounted for on a net basis and accumulated as comprehensive income.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued

(o) Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, the product has been delivered and title of the product has been transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured.

Revenue on contracts, regardless of whether long term or short term, is accounted for principally by the percentage-of-completion method, whereby income is recognized based on the estimated degree of completion of individual contracts.

(p) Income Taxes

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

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

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

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

(q) Earnings Per Share

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

(r) Provisions, Contingent Assets and Contingent Liabilities

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

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) Summary of Significant Accounting Policies and Basis of Presenting Consolidated Financial Statements, Continued(s) Use of Estimates

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

(t) Minority Interest in Consolidated Subsidiaries

Minority interest in consolidated subsidiaries is presented as a separate component of stockholders' equity in the consolidated balance sheets.

(u) Foreign Currency Translation of Foreign Subsidiaries

Assets and liabilities of the Company's foreign subsidiaries and operations are translated into Korean Won at the rate of ₩940.30 to USD1, the basic exchange rate on March 31, 2007. Income and expense items are translated at the average exchange rates prevailing during the fiscal year. Gains and losses resulting from such translations of financial statements are recognized as a foreign-based operations translation gain (loss) in stockholders' equity.

(v) Accounting for the Disposition of an Equity Interest in a Consolidated Subsidiary

Gains or losses on the Company's sale of a subsidiary's stock is recognized in income if, after the sale of the equity interest, the investment is no longer required to be consolidated. If the entity is still required to be consolidated, the Company records the difference between net proceeds and the carrying amount of the stock as an accumulated other comprehensive income to stockholders' equity.

(2) Basis of Translating Consolidated Financial Statements

The consolidated financial statements are expressed in Korean Won and, solely for the convenience of the reader, have been translated into United States dollars at the rate of ₩940.30 to USD1, the basic exchange rate on March 31, 2007. This translation should not be construed as a representation that any or all of the amounts shown could be converted into United States dollars at this or any other rate.

(3) Restricted Deposits

Financial instruments restricted in use as security for maintaining checking accounts as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Long-term financial instruments	₩ <u>46</u>	<u>44</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(4) Transfers of Trade Accounts Receivable

Outstanding export trade accounts and notes receivable transferred to and discounted with third parties as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Export trade accounts receivable	₩ 90	3,195
Notes receivable	<u>13,153</u>	<u>12,515</u>
	<u>₩ 13,243</u>	<u>15,710</u>

(5) Inventories

Inventories as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Merchandise, net of allowance for valuation losses	₩ 858	1,440
Finished goods, net of allowance for valuation losses	141,389	136,231
Semi-finished goods	12,587	13,329
Work-in-process, net of allowance for valuation losses	171,928	218,190
Raw materials, net of allowance for valuation losses	813,444	878,729
Subsidiary material, net of allowance for valuation losses	605	567
Supplies	20,209	19,751
By-products	4,897	4,267
Completed buildings (note 26)	2,980	2,745
Sites for building lotting-out construction (note 26)	13,613	11,571
Goods-in-transit	<u>25,569</u>	<u>12,949</u>
	<u>₩ 1,208,079</u>	<u>1,299,769</u>

(6) Other Current Assets

Other current assets as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Accrued income	₩ 2,799	242
Other receivables (note 20)	37,842	25,517
Prepaid expenses	35,634	7,026
Prepaid income taxes	3	396
Trade guarantee deposits	145	122
Short-term loans to employees	19,237	19,255
Advance payments (notes 11 and 24)	61,732	30,292
Financial derivative assets	40	-
Available-for-sale securities (note 7)	<u>455</u>	<u>555</u>
	<u>₩ 157,887</u>	<u>83,405</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(7) Available-for-sale Securities

Available-for-sale securities as of March 31, 2007 and December 31, 2006 are summarized as follows:

(a) Equity securities

Company	Number of shares	Percentage of ownership	Acquisition cost	Fair value (*5)	Book value	
					March 31, 2007	December 31, 2006
Marketable securities:						
Yonhap Television News	8,380,000	19.95%	₩ 5,102	31,509	31,509	28,366
Crystal Genomics Co., Ltd.	111,000	1.97%	2,875	1,721	1,721	1,582
Oscotech, Inc.	230,770	3.71%	2,250	3,485	3,485	2,250
			10,227	36,715	36,715	32,198
Non-marketable securities:						
Celltrion, Inc.	3,791,368	13.96%	21,245	21,245	21,245	21,245
Nexgen Biotechnologies, Inc.	1,000,000	11.84%	2,150	2,150	2,150	2,150
KT&G Turkey (*1)	9,900	99.00%	3,386	2,050	2,050	869
Cosmo Tobacco Co., Ltd. (*1)	480,000	40.00%	2,540	-	-	-
Innodis Co., Ltd.	110,000	19.64%	55	55	55	55
REXAHN Pharmaceuticals, Inc.	2,500,000	4.97%	2,359	2,359	2,359	2,359
Lifenza, Inc.	29,047	13.01%	1,600	-	-	-
Korea Islet Transplantation Institute, Inc. (*1)	110,500	48.25%	2,000	2,000	2,000	2,000
KT&G Mongolia LLC (*1)	40,000	100.00%	201	201	201	201
Korea Tabacos do Brasil Ltda. (*1)	(*3)	99.90%	394	394	394	394
Genematrix, Inc.	300,000	10.49%	1,500	1,500	1,500	1,500
Litepharmtech, Inc. (*1)	50,000	29.41%	1,000	1,000	1,000	1,000
Hurum, Inc.	7,800	9.75%	39	39	39	39
MD Bioalpha Co., Ltd.	65,852	5.00%	667	667	667	667
OCT USA, Inc.	48,780	19.97%	927	927	927	927
KT&G USA, Inc. (*2)	100,000	100.00%	584	903	903	-
Nongsusan TV Co., Ltd.	200,000	3.09%	1,100	1,100	1,100	1,100
The Korea Economic Daily	287	-	5	5	5	5
Ddrug Co., Ltd. (*4)	-	-	4	4	4	4
Husis Co., Ltd.	-	-	210	13	13	13
Yungjin Co., Ltd. (*1)	16,760	41.90%	168	-	-	-
Yungjin Health Food Co., Ltd. (*1)	17,900	29.80%	90	-	-	-
			42,224	36,612	36,612	34,528
			₩ 52,451	73,327	73,327	66,726

(*1) Investments in small affiliates are accounted for under the cost method for investments since the effect of applying the equity method on its financial statements is not material.

(*2) In 2007, KT&G USA, Inc.'s securities are reclassified as available-for-sale securities since the company is currently in process of liquidation.

(*3) Stock certificates are not issued.

(*4) The company is currently in process of liquidation.

(*5) Non-marketable securities' amounts represent cost since their fair value is not available or readily determinable.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(7) Available-for-sale Securities, Continued(b) Debt securities

Description	Interest rate per annum	Acquisition cost	Fair value	Book value	
				March 31, 2007	December 31, 2006
Current assets:					
Government and municipal bonds	3.0 ~ 7.0%	₩ 455	455	455	555
Non-current assets:					
Government and municipal bonds	3.0 ~ 7.0%	2,404	2,404	2,404	2,430
Oscotech, Inc.	10.0%	1,000	1,000	1,000	1,000
Litepharmtech, Inc.	8.0%	1,000	1,000	1,000	1,000
		4,404	4,404	4,404	4,430
		₩ 4,859	4,859	4,859	4,985

(8) Affiliates' Equity Securities Accounted for Using Equity Method

(a) Affiliates' equity securities accounted for using the equity method as of March 31, 2007 and December 31, 2006 are summarized as follows:

Affiliate	Number of shares	Percentage of ownership	March 31, 2007	December 31, 2006
KGC Sales Co., Ltd.	300,000	100.00%	₩ 1,386	1,111
Yungjin Distribution Co., Ltd.	-	-	-	-
			₩ 1,386	1,111

On January 17, 2007, Yungjin Pharm. Ind. Co., Ltd., a subsidiary of the Company, merged Yungjin Distribution Co., Ltd. into itself, for which use of the equity method had been suspended on reduction of the Company's investment in this entity to less than zero as of December 31, 2006.

(b) Changes in unrealized gains from inter-company transactions for the three-month ended March 31, 2007 are summarized as follows:

Affiliate	Beginning balance	Increase	Realized amount	Ending balance
KGC Sales Co., Ltd.	₩ 148	202	(148)	202

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(8) Affiliates' Equity Securities Accounted for Using Equity Method, Continued

- (c) Details of changes in affiliates' equity securities accounted for using the equity method after acquisition as of March 31, 2007 are as follows:

Affiliate	Acquisition cost	Adjustment to retained earnings		March 31, 2007
		Prior to 2007	2007	
KGC Sales Co., Ltd.	₩ 1,500	(389)	275	1,386

- (d) Details of changes in affiliates' equity securities accounted for using the equity method after acquisition as of December 31, 2006 are as follows:

Affiliate	Acquisition cost	Adjustment to retained earnings		December 31, 2006
		Prior to 2006	2006	
KGC Sales Co., Ltd.	₩ 1,500	(1,178)	789	1,111
Yungjin Distribution Co., Ltd.	800	(800)	-	-
	₩ 2,300	(1,978)	789	1,111

- (e) Summarized financial information of affiliates as of and for the three-month period ended March 31, 2007 is as follows:

Affiliate	Total assets	Total liabilities	Sales	Net income
KGC Sales Co., Ltd.	₩ 4,338	2,749	4,309	329

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(9) Transactions and Balances with Related Companies

(a) The Company's unconsolidated subsidiaries as of March 31, 2007 are as follows:

Related company	Description
KT&G Turkey	The Company's subsidiary
KT&G USA, Inc.	The Company's subsidiary
KT&G Mongolia LLC	The Company's subsidiary
Korea Tabacos do Brasil Ltda.	The Company's subsidiary
Korea Islet Transplantation Institute, Inc.	The Company's subsidiary
KGC Sales Co., Ltd.	Korea Ginseng Corporation's subsidiary
Yungjin Co., Ltd.	Yungjin Pharm. Ind. Co., Ltd.'s subsidiary

(b) Significant transactions and account balances which occurred in the normal course of business with related companies as of March 31, 2007 and December 31, 2006 and for the three-month periods ended March 31, 2007 and 2006 are summarized as follows:

(i) Sales

	2007	2006
KGC Sales Co., Ltd.	₩ 3,540	2,624
KT&G Mongolia LLC	228	-
KT&G USA, Inc.	1,694	-
Yungjin Distribution Co., Ltd.	-	1,703
	₩ 5,462	4,327

(ii) Other expenses

	2007	2006
Korea Tabacos do Brasil Ltda.	₩ 28	30

(iii) Due from affiliates

	2007			2006		
	Trade accounts receivable	Other	Total	Trade accounts receivable	Other	Total
KT&G Turkey	₩ -	1,283	1,283	-	1,249	1,249
KT&G Mongolia LLC	229	238	467	232	238	470
KT&G USA, Inc.	2,261	-	2,261	-	-	-
Yungjin Distribution Co., Ltd.	-	-	-	20,549	-	20,549
Yungjin Co., Ltd.	-	-	-	2,301	-	2,301
KGC Sales Co., Ltd.	2,157	-	2,157	2,047	-	2,047
Yungjin Health Food Co., Ltd.	4,310	-	4,310	4,310	-	4,310
	₩ 8,957	1,521	10,478	29,439	1,487	30,926

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(9) Transactions and Balances with Related Companies, Continued

- (c) Due from the stockholders, directors and employees as of March 31, 2007 and December 31, 2006 are summarized as follows:

	<u>March 31,</u> <u>2007</u>	<u>December 31,</u> <u>2006</u>
Loans for employee housing and tuition	₩ 32,504	33,401
Loans to employee stock ownership association	23,960	25,005
Other	<u>35,757</u>	<u>22,319</u>
	<u>₩ 91,771</u>	<u>80,725</u>

- (d) Details of compensation to uppermost executives for the three-month periods ended March 31, 2007 and 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Short-term payroll	₩ 1,048	919
Post-retirement pay	<u>2,296</u>	<u>777</u>
	<u>₩ 3,344</u>	<u>1,696</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(10) Long-term Loans Receivable

Long-term loans receivable as of March 31, 2007 and December 31, 2006 are as follows:

<u>Classification</u>	<u>Interest rate per annum</u>	<u>Maturity date</u>	<u>March 31, 2007</u>	<u>December 31, 2006</u>
Loan to National Leaf Tobacco Growers Cooperative Federation in support of leaf tobacco cultivation (*1)	0.7%	2007.11.20	₩ 110,000	110,000
Loan to Korea Ginseng Cooperative Federation in support of ginseng cultivation	1.5%	2007.12.21	1,400	1,400
Other	-	-	<u>2,629</u>	<u>2,677</u>
			114,029	114,077
Less: Present value discount account (*2)			(8,258)	(11,416)
Allowance for doubtful accounts			<u>(1,032)</u>	<u>(1,000)</u>
Total net realizable present value			104,739	101,661
Less: Current portion (note 6)			<u>(102,773)</u>	<u>(99,647)</u>
			<u>₩ 1,966</u>	<u>2,014</u>

(*1) The National Agricultural Cooperative Federation guarantees the repayment of loans to the National Leaf Tobacco Growers Cooperative Federation in the same amount.

(*2) The average market interest rate of three-year debentures at the time of loan origination was used in calculating the present value of the loans to the National Leaf Tobacco Growers Cooperative Federation and the Korea Ginseng Cooperative Federation.

(11) Advance Payments

The Company maintains a contract with the farmers under which they are to grow green ginseng and, once the product becomes six years old, sell the ginseng to the Company. As of March 31, 2007 and December 31, 2006, advance payments paid to the farmers in accordance with the contract are as follows:

<u>Classification</u>	<u>Account</u>	<u>March 31, 2007</u>	<u>December 31, 2006</u>
Three-year old ginseng	Long-term advance payments	₩ 31,776	31,776
Four-year old ginseng	Long-term advance payments	26,627	26,627
Five-year old ginseng	Long-term advance payments	<u>22,002</u>	<u>22,012</u>
		80,405	80,415
Six-year old ginseng	Advance payments	<u>59,881</u>	<u>27,433</u>
Total		<u>₩ 140,286</u>	<u>107,848</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(12) Property, Plant and Equipment

(a) Changes in property, plant and equipment for the three-month period ended March 31, 2007 are as follows:

	January 1, 2007	Change of subsidiaries	Increase due to merger	Acquisition	Disposal	Depreciation	Other	March 31, 2007
Land	₩ 381,944	-	-	165	(2,471)	-	547	380,185
Buildings	499,947	-	-	1,910	(2,950)	(6,300)	23,246	515,853
Structures	28,557	-	25	290	(113)	(602)	739	28,896
Machinery and equipment	369,761	-	-	1,500	(725)	(18,071)	5,553	358,018
Vehicles and other transportation equipment	5,872	-	-	169	(17)	(967)	45	5,102
Tools	11,523	-	8	298	(1)	(1,277)	(1)	10,550
Furniture and fixtures	79,928	(52)	-	5,845	(42)	(9,390)	134	76,423
Other tangible fixed assets	605	-	-	6	-	-	-	611
Construction-in-progress	84,607	-	-	25,435	-	-	(30,265)	79,777
	₩ <u>1,462,744</u>	<u>(52)</u>	<u>33</u>	<u>35,618</u>	<u>(6,319)</u>	<u>(36,607)</u>	<u>(2)</u>	<u>1,455,415</u>

(b) Changes in property, plant and equipment for the year ended December 31, 2006 are as follows:

	January 1, 2006	Change of subsidiaries	Acquisition	Disposal	Depreciation	Other (*)	December 31, 2006
Land	₩ 359,409	416	21,645	(3,286)	-	3,760	381,944
Buildings	465,803	815	14,349	(15,128)	(22,769)	56,877	499,947
Structures	27,509	831	1,312	(400)	(2,382)	1,687	28,557
Machinery and equipment	306,399	2,629	9,132	(1,816)	(66,658)	120,075	369,761
Vehicles and other transportation equipment	9,106	52	639	(85)	(3,902)	62	5,872
Tools	11,191	134	2,461	(104)	(4,529)	2,370	11,523
Furniture and fixtures	76,104	142	34,242	(137)	(32,331)	1,908	79,928
Other tangible fixed assets	461	92	45	-	-	7	605
Construction-in-progress	80,696	-	201,169	-	-	(197,258)	84,607
	₩ <u>1,336,678</u>	<u>5,111</u>	<u>284,994</u>	<u>(20,956)</u>	<u>(132,571)</u>	<u>(10,512)</u>	<u>1,462,744</u>

(*) For the year ended December 31, 2006, construction-in-progress amounting to ₩9,893 is transferred to sites for building lotting-out construction.

(13) Officially Declared Value of Land

The officially declared value of land at March 31, 2007, as announced by the Minister of Construction and Transportation, is ₩1,258,039. The officially declared value, which is used for government purposes, is not intended to represent fair value.

(14) Insurance

Buildings, structures, machinery and inventories are insured against fire damage up to ₩1,176,751 as of March 31, 2007 with DongBu Insurance Co., Ltd. and others. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(15) Other Assets

Other assets as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Long-term financial instruments (note 3)	₩ 46	44
Long-term accrued interest	48	27
Long-term trade accounts receivable, net of allowance for doubtful accounts of ₩26,475 in 2007 and ₩12,003 in 2006	2,524	-
Long-term advance payments, net of allowance for doubtful accounts of ₩804 in 2007 and 2006 (notes 11 and 24)	80,619	80,603
	₩ <u>83,237</u>	<u>80,674</u>

(16) Other Current Liabilities

Other current liabilities as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Withholdings	₩ 22,060	15,718
Unearned income	395	418
Withholding guarantee deposits received	212	212
Provision for mileage program	2,796	2,035
	₩ <u>25,463</u>	<u>18,383</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(17) Short-term Borrowings

Short-term borrowings as of March 31, 2007 and December 31, 2006 are summarized as follows:

Type of borrowings	Lender	Interest rate per annum	March 31, 2007	December 31, 2006
Credit loans	Hana Bank	5.64%	₩ 13,000	13,000
Credit loans	Hana Bank	6.45~6.51%	3,500	3,500
Loans for facilities	Hana Bank	6.37%	8,000	8,000
Loans for purchasing capital	Hana Bank	5.35~5.50%	871	815
General loan	Hana Bank	5.22%	1,200	1,200
Comprehensive export financing loan	Export-Import Bank of Korea	5.04%	2,000	2,000
Commercial paper	Hana Securities Co., Ltd.	5.10%	5,000	10,000
Commercial paper	Korea Exchange Bank	5.18~5.75%	10,000	15,000
Commercial paper	Woori Bank	5.70~6.20%	10,000	10,000
Commercial paper	Kumho Investment Bank	5.90%	5,000	5,000
Commercial paper	SK Securities Co., Ltd.	6.37%	5,338	10,000
Commercial paper	Woori Securities Co., Ltd.	5.90%	15,000	-
Commercial paper	Shinheung Securities Co., Ltd.	5.90%	5,000	-
Loans for foreign currency working capital	Korea Exchange Bank	1Y LIBOR+0.80%	5,111	2,271
Loans for foreign currency working capital	Standard Chartered First Bank Korea Ltd.	1Y LIBOR+0.80%	4,598	-
			₩ <u>93,618</u>	<u>80,786</u>

(18) Long-term Borrowings

(a) Long-term borrowings as of March 31, 2007 and December 31, 2006 are summarized as follows:

Type of borrowings	Lender	Maturity date	Interest rate per annum	March 31, 2007	December 31, 2006
Energy Rationalization Fund	Hana Bank	2013. 03.15	3.75%	₩ <u>1,402</u>	<u>1,402</u>

(b) Repayment schedule for the Company's long-term borrowings as of March 31, 2007 is as follows:

Period ending March 31,	Amount
2008	₩ -
2009	210
2010	280
2011	280
thereafter	<u>632</u>
	₩ <u>1,402</u>

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Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(19) Retirement and Severance Benefits

Changes in the retirement and severance benefits for the three-month period ended March 31, 2007 and the year ended December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Estimated retirement and severance benefits accrual at beginning of period	₩ 208,923	160,891
Increase due to change of consolidated subsidiaries	-	2,126
Provision for retirement and severance benefits	3,068	57,437
Payments (*)	<u>(14,890)</u>	<u>(11,531)</u>
Estimated retirement and severance benefits accrual at end of period	197,101	208,923
Deposit for severance benefits trust	(106,401)	(108,939)
Contribution to the National Pension Fund	<u>(478)</u>	<u>(478)</u>
Net balance at end of period	₩ <u>90,222</u>	<u>99,506</u>

(*) Compensations paid by treasury stock amounting to ₩6,336 for the three-month period ended March 31, 2007 are included.

The Company maintains employees' severance benefit trust arrangements with Samsung Life Insurance Co., Ltd. and other financial institutions. Under these arrangements, the Company has made an aggregate deposit in the amount equal to 54.0% and 52.1% of the reserve balances of retirement and severance benefits as of March 31, 2007 and December 31, 2006, respectively. This deposit is to be used to make the required payments to the retirees and accounted for as a reduction of the reserve balance.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(20) Assets and Liabilities Denominated in Foreign Currencies

Details of assets and liabilities denominated in foreign currencies as of March 31, 2007 and December 31, 2006 are as follows: (In thousands of USD, JPY, NTD, HKD, EUR and GBP)

		Foreign currency		Korean Won equivalent	
		2007	2006	2007	2006
Assets:					
Cash and cash equivalents	USD	8,944	1,708	₩ 8,410	1,587
	JPY	86,888	67,453	692	527
	NTD	1,759	4,520	50	129
	USD	87,593	118,793	82,364	110,430
Trade accounts receivable	JPY	156,675	119,388	1,249	933
	HKD	1,441	1,495	173	179
	NTD	295	89	8	3
	USD	259	134	243	125
Other receivables	USD	259	134	243	125
Long-term deposits in the Escrow Fund	USD	<u>57,628</u>	<u>49,065</u>	<u>54,187</u>	<u>45,611</u>
Total	USD	154,424	169,700		
	JPY	243,563	186,841		
	HKD	1,441	1,495		
	NTD	<u>2,054</u>	<u>4,609</u>	₩ <u>147,376</u>	<u>159,524</u>
Liabilities:					
Trade accounts payable	USD	10,789	7,148	₩ 10,145	6,645
	EUR	723	-	907	-
	JPY	14,609	11,728	116	92
	GBP	-	96	-	175
Short-term borrowings	USD	<u>10,410</u>	<u>2,450</u>	<u>9,709</u>	<u>2,271</u>
Total	USD	21,199	9,598		
	EUR	723	-		
	JPY	14,609	11,728		
	GBP	<u>-</u>	<u>96</u>	₩ <u>20,877</u>	<u>9,183</u>

(21) Capital Adjustments

Capital adjustments as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Treasury stock	₩ <u>(318,573)</u>	<u>(321,904)</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(22) Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of March 31, 2007 and December 31, 2006 is summarized as follows:

	March 31, 2007	December 31, 2006
Unrealized gain on valuation of available-for-sale securities	₩ 19,036	15,929
Unrealized gain on valuation of equity method investment securities	755	1,009
Cumulative adjustment for foreign currency translation	(698)	(1,147)
	₩ <u>19,093</u>	<u>15,791</u>

(23) Retained Earnings

(a) Retained earnings as of March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Legal reserve	₩ 602,937	602,937
Reserve for business expansion	698,881	698,881
Reserve for business rationalization	12,851	12,851
Reserve for research and human resource development	45,000	45,000
Reserve for loss on reissuance of treasury stock	26,646	26,646
Other appropriations	350,000	880,000
Unappropriated (undisposed) retained earnings (deficit) at end of period	134,738	(204,966)
	₩ <u>1,871,053</u>	<u>2,061,349</u>

(b) Legal Reserve

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

(c) Reserve for Business Expansion

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

(d) Reserve for Business Rationalization

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

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(23) Retained Earnings, Continued

(e) Other Reserves

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

(24) Commitments and Contingencies

The Company has entered into a purchase contract with the National Leaf Tobacco Growers Cooperative Federation (the "Federation"), which has been given powers of attorney from tobacco cultivators for sales of their leaf tobacco. In addition, the Company has committed to the Federation to provide training programs to leaf tobacco growers and bear the personnel costs of the Federation.

The Company recorded as a long-term deposit the amounts paid into the Escrow Fund of State governments in the United States against potential litigation and damages relative to the tobacco exportation into the United States. The Escrow Fund would be refunded, if the Company did not indemnify the state governments for damages for 25 years on the ground that the Company did not sell cigarettes illegally.

As of March 31, 2007, tobacco lawsuits claiming damages of ₩1,282 were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligation to notify smokers of the potential health hazards of smoking. The final outcome of the litigation cannot be predicted as of March 31, 2007. The amount of the liability the Company may ultimately have with respect to the litigation cannot be reasonably estimated as of March 31, 2007.

As of March 31, 2007, the Company has provided to the National Agricultural Cooperative Federation ("NACF") and another bank guarantees in the aggregate of ₩12,962 for the customers who made a financing agreement with these lenders.

The Company has entered into Letter of Credit agreements with the NACF and other banks on the aggregate limit set at USD134,000.

As of March 31, 2007, the Company's trade accounts receivable arisen from export of cigarettes was insured against dishonor up to USD29,400 by an export guaranty insurance with the Korea Export Insurance Corporation.

As of March 31, 2007, the Company has been provided with a foreign currency payment guarantee for local dealers in Russia and another country up to USD71,600 by Korea Exchange Bank and other financial institutions.

The Company made a currency forward contract with the Korea Exchange Bank and as of March 31, 2007, with the outstanding amount of USD7,000.

The Company maintains a contract with the farmers who grow six-year old green ginseng for easier procurement. As of March 31, 2007 and December 31, 2006, advance payments and long-term advance payments paid to the farmers in accordance with the contract amounted to ₩140,286 and ₩107,848, respectively.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(24) Commitments and Contingencies, Continued

As of March 31, 2007, the Company has entered into note discounting contracts with Hana Bank and other financial institutions with line of credit of ₩22,000, and amounts of outstanding trade notes receivable transferred and notes discounted and endorsed total ₩13,243.

As of March 31, 2007, the Company has provided 15 blank notes and 5 blank checks to Hana Bank and other financial institutions as collateral for its long-term borrowings and trade agreements.

(25) Reserve for Tobacco Production Stabilization Fund

The Company has entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund with the target set at ₩410,000 by 2008 for the purpose of stabilizing tobacco production. Under the agreement, the Company is obligated to make up the deficiency, should the fund fall short of the target. The Company estimates the deficiency at the end of each period and provides for a provision to fully fund the tobacco production stabilization program by 2008.

In addition, effective December 30, 2004, the levy per pack of cigarettes which was imposed for the purpose of raising the fund was increased to 15 Korean Won from 10 Korean Won. However, due to the uncertainty as to the legality and use of the 5 Korean Won increase per pack of cigarettes, the Company did not take into account the effect of this increase in estimating the deficiency.

Changes in the Reserve for Tobacco Production Stabilization Fund for the three-month period ended March 31, 2007 and the year ended December 31, 2006 are summarized as follows:

	March 31, 2007	December 31, 2006
Beginning balance	₩ 74,484	55,753
Provision for Tobacco Production Stabilization Fund	4,301	18,731
Ending balance	₩ <u>78,785</u>	<u>74,484</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(26) Building Lotting-out Construction Contracts

(a) Building lotting-out construction contracts as of March 31, 2007 are summarized as follows:

	<u>Builder</u>	<u>Construction period</u>	<u>Location</u>
Apartment buildings	SK Engineering & Construction Co., Ltd.	2006 ~ 2009	Jeonju city

(b) Details of installment sales as of March 31, 2007 are summarized as follows:

	<u>Expected contract amount</u>	<u>Confirmed contract amount</u>	<u>Recognized revenue</u>		<u>Unrecognized revenue</u>
			<u>Prior to 2007</u>	<u>2007</u>	
Apartment buildings in Jeonju (*)	₩ <u>284,984</u>	<u>42,587</u>	<u>460</u>	<u>63</u>	₩ <u>284,461</u>

(*) Revenue is recognized only to the extent of the recognized costs that are recoverable, because the aggregate estimated costs and the completion percentage cannot be estimated reliably as of March 31, 2007.

(c) Cost of installment sales of store units for the three-month periods ended March 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Outsourcing cost	₩ 2,340	5,003
Land and completed buildings:		
Beginning of the period	14,316	9,153
End of the period	<u>(16,593)</u>	<u>(3,225)</u>
Cost of sales of buildings	₩ <u>63</u>	<u>10,931</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(27) Income Taxes

- (a) The Company is subject to a number of taxes based upon taxable income which result in the following normal rates:

<u>Taxable income</u>	<u>Prior to 2005</u>	<u>Thereafter</u>
Up to ₩ 100	16.5%	14.3%
Over ₩ 100	29.7%	27.5%

In December 2003, the Korean government reduced the corporate income tax rate (including resident tax) beginning in 2005. Specifically, effective January 1, 2005, the income tax rate was reduced from 29.7% to 27.5%.

- (b) The components of income tax expense for the three-month periods ended March 31, 2007 and 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Current income tax expense	₩ 57,664	41,550
Deferred income tax expense (benefit)	10,245	(2,369)
Income tax expense benefit charged (credited) directly to the stockholders' equity	<u>(2,915)</u>	<u>2,437</u>
	<u>₩ 64,994</u>	<u>41,618</u>

- (c) The provision for income taxes calculated using the normal tax rates differs from the actual provision for the three-month periods ended March 31, 2007 and 2006 for the following reasons:

	<u>2007</u>	<u>2006</u>
Provision for income taxes at normal tax rate	₩ 61,562	44,539
Tax effects of permanent differences, net	(4,718)	609
Tax credit	(1,517)	(726)
Changes in valuation allowance for deferred income tax assets (liabilities) and other	<u>9,667</u>	<u>(2,804)</u>
Actual provision for income taxes	<u>₩ 64,994</u>	<u>41,618</u>

The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 33.6% and 30.2% for the three-month periods ended March 31, 2007 and 2006, respectively.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(27) Income Taxes, Continued

- (d) The tax effects of temporary differences that result in significant portions of the deferred income tax assets and liabilities as of March 31, 2007 and December 31, 2006 are presented below:

	March 31, 2007	December 31, 2006
Deferred income tax assets:		
Provision for severance and retirement benefits	₩ 31,523	31,780
Loss on valuation of inventories	7,778	5,384
Depreciation	4,907	5,182
Bad debts	1,147	1,426
Impairment losses on property, plant and equipment	516	754
Present value discounts	2,271	3,140
Provision for Tobacco Production Stabilization Fund	21,667	20,483
Other	4,749	5,169
	<u>74,558</u>	<u>73,318</u>
Total deferred tax assets		
Deferred income tax liabilities:		
Deposit for severance and retirement benefits trust	(28,281)	(28,750)
Reserve for research and human resource development	(21,629)	(23,201)
Equity method investment securities	(99,193)	(86,984)
Reserve for losses on reissuance of treasury stock	(7,328)	(7,328)
Available-for-sale securities	(7,221)	(6,042)
Treasury stock	(15,531)	(15,636)
Other	(1,376)	(679)
	<u>(180,559)</u>	<u>(168,620)</u>
Total deferred tax liabilities		
Net deferred tax liability	(106,001)	(95,302)
Less: Current portion	9,068	8,226
	<u>(115,069)</u>	<u>(103,528)</u>
Deferred tax liabilities	₩	(103,528)

- (e) Effective January 1, 2005, the Company adopted SKAS No. 16,
- Income Taxes*
- . In accordance with SKAS No. 16, deferred taxes are recognized on the temporary differences related to unrealized gains and losses that were reported as a separate component of stockholders' equity and the tax effect of the changes in these accounts is charged or credited directly to the separate component of the stockholders' equity. Income tax expenses charged or credited directly to the separate component of stockholders' equity for the three-month periods ended March 31, 2007 and 2006 are as follows:

	2007	2006
Gain on reissuance of treasury stock	₩ (1,747)	-
Unrealized gain on valuation of available-for-sale securities	(1,179)	2,437
Unrealized gain on valuation of equity method investments	(2)	-
Unrealized loss on valuation of equity method investments	13	-
	<u>(2,915)</u>	<u>2,437</u>
	₩	2,437

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Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(27) Income Taxes, Continued

- (f) Under SKAS No. 16, the deferred tax amounts should be presented as a net current asset or liability and a net non-current asset or liability. In addition, the Company is required to disclose aggregate deferred tax assets (liabilities). As of March 31, 2007, details of aggregate deferred tax assets (liabilities) are as follows:

Description	Temporary differences at March 31, 2007	Deferred tax assets (liabilities)	
		Current	Non-current
Deferred tax assets:			
Provision for severance and retirement benefits	₩ 131,071	-	31,523
Loss on valuation of inventories	34,460	7,778	-
Depreciation	7,411	-	4,907
Bad debts	49,628	1,147	-
Impairment losses on property, plant and equipment	2,239	-	516
Present value discounts	8,259	-	2,271
Provision for Tobacco Production Stabilization Fund	78,784	-	21,667
Other	23,461	900	3,849
	<u>335,313</u>	<u>9,825</u>	<u>64,733</u>
Deferred tax liabilities:			
Deposit for severance and retirement benefits trust	(106,224)	-	(28,281)
Reserve for research and human resource development	(78,650)	-	(21,629)
Equity method investment securities	(368,654)	-	(99,193)
Reserve for losses on reissuance of treasury stock	(26,646)	-	(7,328)
Available-for-sale securities	(26,269)	-	(7,221)
Treasury stock	(56,475)	-	(15,531)
Other	(4,695)	(757)	(619)
	<u>(667,613)</u>	<u>(757)</u>	<u>(179,802)</u>
	₩ <u>(332,300)</u>	<u>9,068</u>	<u>(115,069)</u>

(28) Earnings Per Share

Earnings per share for the three-month periods ended March 31, 2007 and 2006 are as follows:

	2007	2006
Net income	₩ 129,513	96,756
Weighted-average number of common shares outstanding	<u>133,223,864</u>	<u>145,235,643</u>
Earnings per share in Korean Won	₩ <u>972</u>	<u>666</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(29) Non-cash Investing and Financing Activities

Significant non-cash investing and financing activities for the three-month periods ended March 31, 2007 and 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Retirement of treasury stock	₩ -	160,819
Compensation by treasury stock	9,335	-

(30) Added Value

The components of manufacturing costs and selling and administrative expenses which are necessary in calculating added value for the three-month periods ended March 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Wages and salaries	₩ 93,595	85,179
Provision for severance benefits	3,068	4,906
Employee welfare	11,047	10,437
Rent	4,418	4,033
Depreciation	36,607	31,518
Taxes and dues	<u>4,405</u>	<u>5,165</u>
	₩ <u>153,140</u>	<u>141,238</u>

(31) Employee Welfare and Contributions to Society

For employee welfare, the Company maintains a refectory, an infirmary, athletic facilities, a scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spent for the three-month periods ended March 31, 2007 and 2006 are estimated at ₩11,047 and ₩10,437, respectively.

The Company donated ₩6,470 and ₩12,497 to the KT&G Social Welfare Foundation and others for the three-month periods ended March 31, 2007 and 2006, respectively.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(32) Selling, General and Administrative Expenses

The details of selling, general and administrative expenses for the three-month periods ended March 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Salaries	₩ 53,511	49,573
Provision for severance benefits	1,985	3,877
Welfare	7,007	6,569
Travel	1,754	1,425
Communications	1,198	1,019
Utilities	1,865	1,858
Taxes and dues	3,561	4,480
Supplies	742	653
Uniforms	3	2
Rent	1,794	1,724
Depreciation	13,853	11,432
Amortization	1,108	1,109
Repairs and maintenance	672	691
Vehicles	1,735	1,677
Insurance	369	306
Commissions	20,116	14,673
Transportation and warehousing	7,874	5,580
Entertainment	428	578
Conferences	1,616	1,973
Advertising	38,136	36,757
Training	2,219	1,745
Prizes and rewards	463	330
Cooperation	194	131
Normal research and development	4,924	4,643
Sample	1	9
Bad debts	1,992	675
Miscellaneous	524	375
	<u>₩ 169,644</u>	<u>153,864</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(33) Segment Information

- (a) The Company has three reportable operating segments - manufacturing and selling tobacco (the tobacco segment), manufacturing and selling ginseng products (the ginseng segment), and other.
- (b) Information on each operating segment as of and for the three-month period ended March 31, 2007 is as follows:

		<u>Tobacco segment</u>	<u>Ginseng segment</u>	<u>Other</u>	<u>Consolidation adjustment</u>	<u>Total</u>
Sales	₩	515,407	117,034	31,373	-	663,814
Operating income (loss)		156,885	37,825	(417)	2,732	197,025
Total assets		4,257,642	562,631	155,899	(523,126)	4,453,046

- (c) Information on each operating segment as of and for the three-month period ended March 31, 2006 is as follows:

		<u>Tobacco segment</u>	<u>Ginseng segment</u>	<u>Other</u>	<u>Consolidation adjustment</u>	<u>Total</u>
Sales	₩	436,559	101,005	38,669	-	576,233
Operating income (loss)		115,433	33,972	(507)	1,559	150,457
Total assets		4,011,606	443,798	138,607	(424,989)	4,169,022

(34) Merger

On January 17, 2007, Yungjin Pharm. Ind. Co., Ltd., a subsidiary of the Company, merged Yungjin Distribution Co., Ltd. into itself with the merger ratio of 1:0, as the latter was a wholly-owned subsidiary of the former and issuance of new shares was not involved in the merger. The assets and liabilities to which the Company succeeded as a result of the merger are as follows:

	<u>Amount</u>
Assets:	
Current assets	₩ 2,983
Non-current assets	<u>216</u>
	<u>3,199</u>
Liabilities:	
Current liabilities	21,282
Long-term liabilities	<u>-</u>
	<u>21,282</u>
Net assets succeeded to	₩ <u><u>(18,083)</u></u>

In merging with the subsidiary, the Company succeeded to the subsidiary's assets and liabilities in book value in its balance sheet as of January 17, 2007. Accordingly, the balance of retained earnings of YJPI as of January 17, 2007 decreased by ₩18,083.