

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Financial Statements

December 31, 2008 and 2007

(With Independent Auditors' Report Thereon)

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Independent Auditors' Report

Based on a report originally issued in Korean

The Board of Directors and Stockholders
KT&G Corporation:

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2008 and 2007, and the results of their operations, changes in their equity and their cash flows for the years then ended in conformity with accounting principles generally accepted in the Republic of Korea.

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

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

As discussed in note 2(a) to the consolidated financial statements, accounting principles and auditing 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, changes in equity and cash flows in accordance with accounting principles and practices generally accepted in countries other than the Republic of Korea. In addition, the procedures and practices utilized in the Republic of Korea to audit such 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 auditing standards and their application in practice.

As discussed in note 24 to the consolidated financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩759 million for the harmful effects of smoking. 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 December 31, 2008 and 2007, the balance of advance payments paid to the farmers in accordance with the contract amounted to ₩140,628 million and ₩116,289 million, respectively.

As discussed in note 2(a) to the consolidated financial statements, the financial statements of KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. whose total assets as of December 31, 2007 exceeded ₩7,000 million was included in the Company's consolidated financial statements.

As discussed in note 40 to the consolidated financial statements, all listed companies are required to comply with International Financial Reporting Standards ("K-IFRS") from 2011 and the Company has decided to early-adopt K-IFRS in 2009.

Seoul, Korea
March 23, 2009

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

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets

As of December 31, 2008 and 2007

	Note	2008		2007
		Korean Won	U.S. dollars (note 3)	Korean Won
<i>In millions of Won and thousands of US dollars</i>				
Assets				
Cash and cash equivalents	23	₩ 105,447	\$ 83,855	₩ 137,687
Short-term financial instruments		1,000	795	1,000
Trade accounts receivable, net of allowance for doubtful accounts of ₩25,533 in 2008 and ₩11,420 in 2007	5,10,23,24	481,548	382,941	369,804
Other receivables, net of allowance for doubtful accounts of ₩5,675 in 2008 and ₩5,911 in 2007	23	75,647	60,157	34,055
Inventories	6,14	1,484,651	1,180,637	1,317,705
Current portion of long-term loans, net of allowance for doubtful accounts of nil in 2008 and ₩123 in 2007	10	28,071	22,323	19,504
Current deferred tax assets	32	12,569	9,995	17,605
Advance payments, net of allowance for doubtful accounts of nil in 2008 and ₩85 in 2007	11,24	29,039	23,093	23,716
Other current assets	7	8,986	7,145	10,920
Total current assets		<u>2,226,958</u>	<u>1,770,941</u>	<u>1,931,996</u>
Available-for-sale securities	8	309,343	245,998	257,098
Equity method investment securities	9	2,314	1,840	35,969
Long-term loans	10	89,878	71,474	99,178
Guarantee deposits paid		57,908	46,050	51,162
Guarantee deposits for membership		23,173	18,428	22,137
Long-term deposits in escrow fund	23,24	110,261	87,683	66,633
Property, plant and equipment, net	12,13,14,15	1,624,751	1,292,049	1,559,289
Intangible assets, net	16,17	4,942	3,930	8,659
Long-term advance payments, net of allowance for doubtful accounts of ₩1,088 in 2008 and ₩934 in 2007	11,24	117,152	93,163	96,493
Deferred income tax assets	32	1,171	931	1,765
Other non-current assets	18	4,337	3,448	3,723
Total non-current assets		<u>2,345,230</u>	<u>1,864,994</u>	<u>2,202,106</u>
Total assets		₩ <u>4,572,188</u>	\$ <u>3,635,935</u>	₩ <u>4,134,102</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets, Continued

As of December 31, 2008 and 2007

	Note	2008		2007
		Korean Won	U.S. dollars (note 3)	Korean Won
<i>In millions of Won and thousands of US dollars except share data</i>				
Liabilities				
Trade accounts payable	23	₩ 37,453	\$ 29,784	₩ 15,202
Short-term borrowings	15,20,24	54,455	43,305	38,097
Advance receipts		4,280	3,403	6,127
Value added tax payable		125,247	99,600	128,985
Accrued expenses		35,031	27,858	17,343
Other payables	23	154,148	122,582	105,693
Income taxes payable	32	187,550	149,145	220,428
Tobacco excise and other taxes payable		168,423	133,935	181,734
Other current liabilities	19	25,488	20,269	17,297
Total current liabilities		<u>792,075</u>	<u>629,881</u>	<u>730,906</u>
Long-term borrowings	15,21,24	2,474	1,968	2,733
Retirement and severance benefits	22	59,248	47,116	86,392
Guarantee deposits received		23,146	18,406	25,051
Deferred income tax liabilities	32	137,154	109,069	124,535
Reserve for sales returns		1,960	1,558	894
Reserve for lawsuit		-	-	364
Total non-current liabilities		<u>223,982</u>	<u>178,117</u>	<u>239,969</u>
Total liabilities		<u>1,016,057</u>	<u>807,998</u>	<u>970,875</u>
Stockholders' equity				
Common stock of ₩5,000 par value				
Authorized - 800,000,000 shares				
Issued - 138,792,497 shares in 2008				
and 143,442,497 shares in 2007				
Outstanding - 128,698,800 shares in 2008				
and 130,839,907 shares in 2007		954,959	759,411	954,959
Capital surplus		471,144	374,667	465,866
Capital adjustments	25	(224,650)	(178,648)	(414,947)
Accumulated other comprehensive income	26	30,672	24,391	2,496
Retained earnings	27	2,306,930	1,834,537	2,134,736
Minority interest in consolidated subsidiaries		17,076	13,579	20,117
Total stockholders' equity		<u>3,556,131</u>	<u>2,827,937</u>	<u>3,163,227</u>
Total liabilities and stockholders' equity		<u>₩ 4,572,188</u>	<u>\$ 3,635,935</u>	<u>₩ 4,134,102</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Statements of Income

For the years ended December 31, 2008 and 2007

	Note	2008		2007
		Korean Won	U.S. dollars (note 3)	Korean Won
<i>In millions of Won and thousands of US dollars, except earnings per share</i>				
Sales	10,28,36	₩ 3,363,531	\$ 2,674,777	₩ 3,046,384
Cost of sales	10,28,30,31	1,375,659	1,093,964	1,313,029
Gross profit		1,987,872	1,580,813	1,733,355
Selling, general and administrative expenses	10,29,30,31	819,912	652,018	753,326
Operating income	36	1,167,960	928,795	980,029
Interest income		24,484	19,470	41,497
Interest expense		(3,994)	(3,176)	(4,502)
Other bad debt expense		(1,275)	(1,014)	(1,219)
Reversal of allowance for doubtful allowance		1,172	932	1,913
Gain (loss) on foreign currency transactions, net		52,581	41,814	(490)
Gain on foreign currency translation, net		24,948	19,839	2,413
Gain on sale of property, plant and equipment, net		12,286	9,770	5,392
Loss on impairment of available-for-sale securities	8	-	-	(2,163)
Loss on impairment of property, plant and equipment		(429)	(341)	(2,179)
Provision for Tobacco Production Stabilization Fund		-	-	(35,516)
Loss on prior period adjustment	2	-	-	(20,959)
Gain on valuation of equity method investment securities, net	9	15	12	1,188
Donations	31	(34,092)	(27,111)	(30,293)
Other, net		(7,896)	(6,279)	2,688
Other income		67,800	53,916	(42,230)
Income before income taxes		1,235,760	982,711	937,799
Income taxes	32	346,405	275,471	291,394
Net income		₩ 889,355	\$ 707,240	₩ 646,405
Controlling Interest in net income	38	892,396	709,659	662,606
Minority interest in losses of consolidated subsidiaries	38	(3,041)	(2,419)	(16,201)
Earnings per share				
Basic earnings per share	33	₩ 6,857	\$ 5	₩ 5,003

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Statements of Changes in Equity

For the years ended December 31, 2008 and 2007

<i>In millions of Won</i>	Korean Won							U.S. dollars (note 3)	
	Capital stock	Capital surplus	Capital adjustment	Accumulated other comprehensive income	Retained earnings	Minority interest	Total stock holders' equity		
Balance at January 1, 2007	₩	954,959	335,350	(321,904)	15,791	2,061,349	20,218	3,065,763	
Dividends		-	-	-	-	(319,712)	-	(319,712)	
Net income		-	-	-	-	662,606	(16,201)	646,405	
Decrease in unrealized gain on valuation of available-for-sale securities		-	-	-	(13,829)	-	-	(13,829)	
Increase in unrealized gain on valuation of equity method investment securities		-	-	-	26	-	-	26	
Reacquisition of treasury stock		-	-	(455,035)	-	-	-	(455,035)	
Retirement of treasury stock		-	-	269,411	-	(269,411)	-	-	
Compensation by treasury stock		-	128,823	92,581	-	-	-	221,404	
Changes in translation adjustments		-	-	-	508	-	-	508	
Issuance of common stock of subsidiaries		-	1,693	-	-	-	16,177	17,870	
Other		-	-	-	-	(96)	(77)	(173)	
Balance at December 31, 2007	₩	<u>954,959</u>	<u>465,866</u>	<u>(414,947)</u>	<u>2,496</u>	<u>2,134,736</u>	<u>20,117</u>	<u>3,163,227</u>	
<i>In millions of Won and thousands of US dollars</i>	Korean Won							U.S. dollars (note 3)	
	Capital stock	Capital surplus	Capital adjustment	Accumulated other comprehensive income	Retained earning	Minority interest	Total stock holder's equity		Total stock holder's equity
Balance at January 1, 2008	₩	954,959	465,866	(414,947)	2,496	2,134,736	20,117	3,163,227	\$ 2,515,489
Dividends		-	-	-	-	(340,449)	-	(340,449)	(270,735)
Net income		-	-	-	-	892,396	(3,041)	889,355	707,240
Increase in unrealized gain on valuation of available-for-sale securities		-	-	-	25,637	-	-	25,637	20,387
Reacquisition of treasury stock		-	-	(194,128)	-	-	-	(194,128)	(154,376)
Retirement of treasury stock		-	-	379,753	-	(379,753)	-	-	-
Compensation by treasury stock		-	4,375	2,377	-	-	-	6,752	5,370
Changes in translation adjustments		-	-	-	3,442	-	-	3,442	2,737
Increase in unearned stock compensation		-	-	2,295	-	-	-	2,295	1,825
Other		-	903	-	(903)	-	-	-	-
Balance at December 31, 2008	₩	<u>954,959</u>	<u>471,144</u>	<u>(224,650)</u>	<u>30,672</u>	<u>2,306,930</u>	<u>17,076</u>	<u>3,556,131</u>	\$ <u>2,827,937</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows

For the years ended December 31, 2008 and 2007

*In millions of Won
and thousands of US dollars*

	2008		2007	
	Korean Won	U.S. dollars (note 3)	Korean Won	Korean Won
Cash flows from operating activities				
Net income	₩ 889,355	\$ 707,240	₩ 646,405	
Adjustments for:				
Depreciation and amortization	163,634	130,127	155,394	
Loss (gain) on valuation of inventories, net	(18,129)	(14,416)	3,220	
Bad debt expense	11,578	9,207	7,242	
Loss on impairment of available-for-sale securities	-	-	2,163	
Gain on valuation of equity method investment securities, net	(15)	(12)	(1,188)	
Gain on foreign currency translation, net	(25,008)	(19,887)	(2,402)	
Other bad debt expense	1,275	1,014	1,219	
Reversal of allowance for doubtful accounts	(1,172)	(932)	(1,913)	
Provision for retirement and severance benefits	55,714	44,305	40,335	
Loss on prior period adjustment	-	-	20,959	
Amortization of present value discounts	-	-	(11,416)	
Provision for Tobacco Production Stabilization Fund	-	-	35,516	
Other, net	(4,387)	(3,489)	(6,648)	
	183,490	145,917	242,481	
Change in assets and liabilities:				
Trade accounts receivable	(123,767)	(98,423)	(36,652)	
Other receivables	(39,821)	(31,667)	(10,222)	
Advance payments	25,075	19,940	29,368	
Prepaid expenses	4,030	3,205	(3,626)	
Inventories	(141,406)	(112,450)	(18,927)	
Long-term advance payments	(48,868)	(38,861)	(37,174)	
Trade accounts payable	16,156	12,848	(7,786)	
Other payables	44,656	35,512	74,349	
Advance receipts	(1,847)	(1,469)	(1,768)	
Withholdings	2,561	2,037	(4,791)	
Value added tax payable	(3,738)	(2,973)	37	
Accrued expenses	23,671	18,824	11,289	
Tobacco excise tax and dues payable	(13,311)	(10,585)	126,346	
Income taxes payable	(32,949)	(26,202)	35,909	
Deferred income taxes, net	9,079	7,220	15,567	
Deposit for severance benefits trust	114,538	91,084	(23,790)	
Retirement pension plan asset	(84,959)	(67,562)	-	
Payments of retirement and severance benefits	(103,375)	(82,207)	(21,518)	
Payments to Tobacco Production Stabilization Fund	-	-	(110,000)	
Others, net	(1,751)	(1,390)	(1,396)	
Net cash provided by operating activities	₩ 716,819	\$ 570,038	₩ 904,101	

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows, Continued

For the years ended December 31, 2008 and 2007

*In millions of Won
and thousands of US dollars*

	2008		2007	
	Korean Won	U.S. dollars (note 3)	Korean Won	
Cash flows from investing activities				
Proceeds from sale of available-for-sale securities	₩ 530	\$ 421	₩ 2,005	
Decrease in short-term financial instruments	-	-	11,940	
Decrease in short-term and long-term loans, net	1,112	884	100,110	
Increase in guarantee deposits, net	(6,647)	(5,286)	(4,320)	
Proceeds from sale of property, plant & equipment	23,206	18,454	26,795	
Purchases of available-for-sale securities	(22,088)	(17,565)	(242,324)	
Increase in long-term deposit in escrow fund	(17,895)	(14,231)	(20,415)	
Purchases of property, plant & equipment	(207,891)	(165,320)	(271,143)	
Purchases of intangible assets	(647)	(515)	(1,710)	
Increase in other investment assets, net	(1,198)	(953)	(2,668)	
Other, net	(962)	(766)	(493)	
Net cash used in investing activities	(232,480)	(184,877)	(402,223)	
Cash flows from financing activities				
Decrease in guarantee deposits received, net	(1,909)	(1,517)	(2,800)	
Increase in short-term borrowings	66,693	53,036	183,978	
Increase in long-term borrowings	22	17	1,541	
Disposal of treasury stock	-	-	235,233	
Repayment of short-term borrowings	(50,434)	(40,107)	(226,662)	
Repayment of current portion of long-term borrowings	(210)	(167)	-	
Reacquisition of treasury stock	(194,128)	(154,376)	(455,035)	
Issuance of common stock of subsidiaries	-	-	17,870	
Payment of dividends	(340,449)	(270,735)	(319,712)	
Net cash used in financing activities	(520,415)	(413,849)	(565,587)	
Net increase (decrease) in cash and cash equivalents from change of subsidiaries in consolidated financial statements	3,836	3,050	(888)	
Increase in cash and cash equivalents due to merger	-	-	415	
	<u>3,836</u>	<u>3,050</u>	<u>(473)</u>	
Net decrease in cash and cash equivalents	(32,240)	(25,638)	(64,182)	
Cash and cash equivalents at beginning of year	137,687	109,493	201,869	
Cash and cash equivalents at end of year	₩ 105,447	\$ 83,855	₩ 137,687	

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

1. Organization and Description of Business

KT&G Corporation (the "Parent Company"), which is engaged in manufacturing and selling tobacco, was established on April 1, 1987 as Korea Monopoly Corporation, a wholly-owned enterprise of the Korean government, pursuant to the Korea Monopoly Corporation Act, in order to secure financing and to promote and develop, through efficient management, the monopoly business of red ginseng and tobacco. On April 1, 1989, the 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 stock on the Korea Exchange on October 8, 1999. On December 27, 2002, the Parent Company changed its name again from Korea Tobacco & Ginseng Corporation to KT&G Corporation.

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

Pursuant to the Korean government's privatization program and management reorganization plan, on December 28, 1998, the stockholders approved a plan to separate the 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, the 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 common stock of the Parent Company), respectively, on the Luxembourg Stock Exchange pursuant to the Korean government's privatization program.

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

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

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(a) Basis of Presenting Consolidated Financial Statements

KT&G Corporation and the controlled subsidiaries (hereinafter referred to collectively as 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 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, changes in equity or cash flows, is not presented in the accompanying consolidated financial statements.

The Company applied the same accounting policies that were adopted in the previous year's consolidated financial statements.

- (i) The consolidated financial statements include the accounts of KT&G and the following controlled subsidiaries as of December 31, 2008. Controlled subsidiaries include entities majority-owned by either KT&G or a controlled subsidiary and other entities where KT&G or its controlled subsidiary owns more than 30% of total outstanding common stock of an investee company 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 and selling ginseng products
Korea Ginseng (HK) Limited ("KGHK") (*1) (*2)	1999	18,866,999	99.99%	Sales of ginseng products in Hong Kong
Yungjin Pharm. Ind. Co., Ltd. ("YJPI") (*4)	1962	65,655,051	55.50%	Manufacturing and selling pharmaceutical products
Tae-a Industry Co., Ltd. ("TAI")	1972	150,000	100.00%	Manufacturing subsidiary material for tobacco
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. ("KTMST") (*2) (*3)	2003	8,999,888	99.99%	Manufacturing and selling tobacco in Turkey

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

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

(*3) KTMST was newly included in the Company's consolidated financial statements since total assets of KTMST as of December 31, 2007 exceeded ₩7,000 million.

(*4) Yungjin Pharm. Ind. Co., Ltd. restated its financial statements as of and for the year ended December 31, 2006 due to adjustments for the accounting errors made in year 2006 and prior periods resulting in an increase in accumulated deficit by ₩20,959 million. However, as the effect of the adjustments on the consolidated financial statements was immaterial, the adjusted loss has been charged to current results of operations for the year ended December 31, 2007.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(a) 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 December 31, 2008 and 2007 are summarized as follows (these amounts have been eliminated in consolidation):

In millions of Won

<u>Transaction Party</u>		<u>Balance Sheet Account</u>		<u>2008</u>	<u>2007</u>
KT&G	KTMST	Trade accounts receivable	₩	1,313	-
KT&G	KTMST	Advance payments		24,128	-
KT&G	KGC	Other receivables		3,184	-
KGC	KT&G	Trade accounts receivable		59	270
KGC	KT&G	Guarantee deposits		2,043	2,043
KGC	KT&G	Prepaid expense		493	336
KGC	KGHK	Trade accounts receivable		6,835	5,037
KGC	YJPI	Trade accounts receivable		130	98
YJPI	KGC	Guarantee deposits		212	212

- (iii) Significant transactions which occurred in the normal course of business with and between consolidated subsidiaries for the years ended December 31, 2008 and 2007 are summarized as follows (these amounts have been eliminated in consolidation):

In millions of Won

<u>Transaction Party</u>		<u>Income Statement Account</u>		<u>2008</u>	<u>2007</u>
KT&G	KGC	Sales	₩	12,176	1,440
KT&G	YJPI	Sales		163	202
KT&G	KTMST	Sales		2,512	-
KT&G	KGC	Other income		1,095	11,545
KT&G	YJPI	Other income		8	1
KT&G	KTMST	Other income		682	-
KGC	KT&G	Sales		1,446	2,223
KGC	YJPI	Sales		1,914	991
KGC	KGHK	Sales		33,363	15,823
KGC	TAI	Sales		25	18
YJPI	KT&G	Sales		121	144
YJPI	KGC	Sales of property, Plant & equipment		-	9,130
TAI	KT&G	Sales		15,321	13,419

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(a) Basis of Presenting Consolidated Financial Statements, Continued

(iv) Adjustment for the financial statements of the subsidiary

One of the subsidiary, Yungjin Pharm. Ind. Co.,Ltd., adopted the revaluation model for land in the year ended December 31, 2008. For consistency of accounting policies, the financial statements of Yungjin Pharm. Ind. Co.,Ltd. were adjusted using the cost model. The adjustment for the financial statements are as follows:

In millions of Won

Account	Non-adjusted value	Adjustment	Adjusted value
Land	₩ 35,491	(22,027);	13,464
Revaluation surplus	22,027	(22,027);	-

(b) Cash Equivalents

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

(c) Short-term Deposits

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

(d) Allowance for Doubtful Accounts

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

(e) Inventories

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-progress; using the moving-average method for raw materials and supplies; and using the specific identification method for goods-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. 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 recognized loss and reversal of loss on valuation of inventories amounting to ₩4,413 million and ₩22,542 million, respectively, for the year ended December 31, 2008. Also, the estimated amounts of inventories in current assets which are not expected to be realized within a year are ₩304,969 million and ₩319,217 million, respectively, as of December 31, 2008 and 2007.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

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

Classification

Upon acquisition, the Company classifies debt and equity securities (excluding investments in subsidiaries, associates and joint ventures) into the following categories: held-to-maturity, available-for-sale or trading securities.

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

Initial recognition

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

Subsequent measurement and income recognition

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

Fair value information

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

Presentation

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

Impairment

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(g) Investment Securities under the Equity Method of Accounting

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

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

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

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

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

Unrealized gains on transactions between the Company and its associate or subsidiaries are eliminated to the extent of the Company's interest in each associate or subsidiary.

Except for when the Company discontinues the application of the equity method as the investment in a subsidiary is reduced to zero, net income and net assets of the parent company's separate financial statements should agree with the parent company's share in the net income and net assets of the consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(h) Property, Plant and Equipment

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

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

Depreciation is computed as follows:

	<u>Depreciation method</u>	<u>Useful lives (years)</u>
Buildings	Straight-line method	10 to 60
Structures	Straight-line method	4 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

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

(i) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the identifiable net assets acquired. Goodwill is amortized on a straight-line basis over 5 years. Where it is no longer probable that goodwill will be recovered from the expected future economic benefits generated by the acquisition, it is expensed immediately.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(j) Intangible Assets

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

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

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

(i) Research and Development Costs

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

(ii) Other Intangible Assets

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

(k) Retirement and Severance Benefits

Employees who have been with the Company for more than one period 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.

The Company introduced a new pension plan, from 2008. Under the Retirement Benefits Regulation, consideration of service requirements under the new plan begins from the date the new plan is effective; the period of service prior to the effective date of the new plan will continue to be covered by the existing retirement benefits plan.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(k) Retirement and Severance Benefits, Continued

The Company introduced a defined benefit pension plan, under which each eligible employee receives a fixed amount of pension after retirement. The Company accrued, as a liability for retirement and severance benefits, lump-sum payments payable to employees who are currently in service, assuming that they left the Company as of the balance sheet date. All employees with a minimum of one year of service are eligible to participate and must elect to participate in the plan. Participants accrue estimated benefits based on actuarial assumptions measured on the balance sheet date at the discounted present value.

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

(l) Foreign Currency Translation

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

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(m) Revenue Recognition

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

Tobacco products sold

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

Lotting-out construction contracts

As soon as, the outcome of a lotting-out construction contract can be estimated reliably, contract revenue and expenses are recognized in the statement of income in proportion to the percentage of completion and sales of lots of the contract. Lotting-out revenue includes the initial amount agreed in the contract plus any variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and can be measured reliably.

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

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

(n) Income Taxes

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

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

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

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(n) Income Taxes, Continued

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

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

(o) 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.

(p) Prior Period Adjustments

Prior period adjustments resulting from other than fundamental errors are charged or credited to net income for the current period. The fundamental errors are defined as errors with such a significant effect on the financial statements for one or more prior periods that those financial statements can no longer be considered to have been reliable at the date of their issue. The prior period adjustments resulting from the fundamental errors are charged or credited to the beginning balance of retained earnings, and the financial statements of the prior year are restated.

(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) Share-based Payments

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(s) Derivatives

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

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

Hedge accounting

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

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

Fair value hedge

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

Cash flow hedge

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

Derivatives that do not qualify for hedge accounting

Changes in the fair value of derivative instruments that are not designated as fair value or cash flow hedges are recognized immediately in the statement of income.

Separable embedded derivatives

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

(t) 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.

(u) Minority Interest in Consolidated Subsidiaries

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

3. 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 ₩1,257.5 to US\$1, the basic exchange rate on December 31, 2008. 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.

4. Restricted Deposits

Financial instruments restricted in use as security for maintaining checking accounts as of December 31, 2008 and 2007 are summarized as follows:

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Long-term financial instruments	₩ 6	44

5. Transfers of Trade Accounts Receivable

Certain of export trade accounts and notes receivable transferred to and discounted with third parties as of December 31, 2008 and 2007 are summarized as follows:

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Export trade accounts receivable	₩ 5,264	2,795
Notes receivable	<u>6,789</u>	<u>7,056</u>
	₩ <u>12,053</u>	<u>9,851</u>

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

6. Inventories

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Merchandise, net of allowance for valuation losses	₩ 792	1,107
Finished goods, net of allowance for valuation losses	149,139	134,164
Semi-finished goods	32,703	20,170
Work-in-progress, net of allowance for valuation losses	296,056	259,059
Raw materials, net of allowance for valuation losses	834,228	804,741
Subsidiary material, net of allowance for valuation losses	966	548
Supplies	23,269	21,856
By-products	3,242	2,641
Unsold buildings (note 28)	121,552	52,150
Sites for building lotting-out construction (notes 13 and 28)	12,728	13,204
Goods-in-transit	<u>9,976</u>	<u>8,065</u>
	<u>₩ 1,484,651</u>	<u>1,317,705</u>

7. Other Current Assets

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Accrued income	₩ 384	326
Prepaid expenses	5,351	9,374
Prepaid income taxes	29	34
Short-term loans	1,073	1,094
Available-for-sale securities (note 8)	<u>2,149</u>	<u>92</u>
	<u>₩ 8,986</u>	<u>10,920</u>

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

December 31, 2008 and 2007

8. Available-for-sale Securities

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

(a) Equity securities (non-current)

<i>In millions of Won, except owned shares and percentage of ownership</i>	Number of shares	Percentage of ownership	Acquisition cost	Fair value	Book value	
					2008	2007
Marketable securities:						
Yonhap Television News (YTN)	8,380,000	19.95%	₩ 5,102	37,249	37,249	28,366
Crystal Genomics Co., Ltd.	172,187	1.67%	3,022	1,722	1,722	1,791
Oscotech, Inc.	230,770	3.51%	2,250	748	748	1,396
Shinhan Financial Group	3,500,000	0.88%	205,532	103,950	103,950	187,250
Rexahn Pharmaceuticals, Inc. (*1)	4,642,858	8.28%	5,158	5,196	5,196	-
Celltrion, Inc. (*1)	13,030,810	12.22%	21,245	129,005	129,005	-
			<u>242,309</u>	<u>277,870</u>	<u>277,870</u>	<u>218,803</u>
Non-marketable securities:						
Celltrion, Inc. (*1)	-	-	-	-	-	21,245
Nexgen Biotechnologies, Inc. (*3)	1,000,000	11.84%	2,150	-	-	-
Cosmo Tobacco Co., Ltd. (*3)	480,000	40.00%	2,540	-	-	-
Innodis, Inc.	110,000	19.64%	55	55	55	55
Rexahn Pharmaceuticals, Inc. (*1)	-	-	-	-	-	5,158
Lifenza, Inc. (*3)	29,047	13.01%	1,600	-	-	-
Korea Islet Transplantation Institute, Inc. (*2)	110,500	48.25%	2,000	2,000	2,000	2,000
KT&G Mongolia LLC (*4)	-	-	-	-	-	201
Korea Tabacos do Brasil Ltda. (*2)	(*6)	99.90%	394	394	394	394
Genematrix, Inc.	300,000	10.14%	1,500	1,500	1,500	1,500
Litepharmtech, Inc. (*2)	77,667	29.46%	1,830	1,830	1,830	1,830
Hurum, Inc.	7,800	9.75%	39	39	39	39
Mazence Co., Ltd. (formerly, MD Bioalpha Co., Ltd.)	197,556	6.86%	733	733	733	733
OCT USA, Inc.	48,780	19.97%	927	927	927	927
Dream Hub PFV Co., Ltd.	3,000,000	1.50%	15,000	15,000	15,000	75
Migami, Inc.	4,286,000	3.77%	2,830	2,830	2,830	-
KT&G Pars (*2)	1,577,754	99.99%	1,697	1,697	1,697	-
KT&G Rus L.L.C. (*2)	(*6)	100%	802	802	802	-
Korea Carbon Finance, Inc. (*2)	100,000	20.00%	500	500	500	-
SJ Biomed Corporation	285,714	14.39%	1,000	1,000	1,000	-
The Korea Economic Daily	287	0.00%	5	5	5	5
Ddrug Co., Ltd. (*5)	-	-	-	-	-	4
Husis Co., Ltd. (*3)	700,000	6.90%	210	-	-	-
Yungjin Co., Ltd. (*3)	16,760	41.90%	168	-	-	-
Yungjin Health Co., Ltd. (*3)	17,900	29.80%	90	-	-	-
			<u>36,070</u>	<u>29,312</u>	<u>29,312</u>	<u>34,166</u>
Total			<u>₩ 278,379</u>	<u>307,182</u>	<u>307,182</u>	<u>252,969</u>

(*1) As Rexahn Pharmaceuticals, Inc. was listed on New York Stock Exchange in the year ended December 31, 2008, Rexahn Pharmaceuticals, Inc. is recorded at the reasonably adjusted value of the market price established in New York Stock Exchange. Celltrion, Inc. was listed on KOSDAQ in the year ended December 31, 2008, Celltrion, Inc. was recorded at the market price established in KOSDAQ.

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8. Available-for-sale Securities, Continued

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

- (*2) Investments in small affiliates are accounted for under the cost method for investments since the effect on their financial statements of applying the equity method is not material.
- (*3) In the prior period, the Company wrote off its investments in Nexgen Biotechnologies, Inc., Lifenza, Inc., Cosmo Tobacco Co., Ltd., Husis Co., Ltd., Yungjin Co., Ltd. and Yungjin Health Co., Ltd. as their decline in value was judged to be other than temporary. Other than the above securities, non-marketable securities were recorded at cost since fair value is not available or readily determinable.
- (*4) The liquidation process of KT&G Mongolia LLC was completed in the year ended December 31, 2008, the Company recorded a gain on sale of available-for-sale securities of ₩80 million.
- (*5) The Company disposed of its investment in Ddrug Co., Ltd. and recognized a loss on sale of available-for-sale securities of ₩4 million in the year ended December 31, 2008.
- (*6) Stock certificates are not issued.

(b) Debt securities

<i>In millions of Won</i>	<u>Interest rate per annum</u>	<u>Acquisition cost</u>	<u>Fair value</u>	<u>Book value</u>	
				<u>2008</u>	<u>2007</u>
Current assets:					
Government and municipal bonds	2.5 ~ 4.0%	₩ 149	149	149	92
Oscotech, Inc.	10.0%	1,000	1,000	1,000	-
Litepharmtech, Inc	8.0%	1,000	1,000	1,000	-
		<u>2,149</u>	<u>2,149</u>	<u>2,149</u>	<u>92</u>
Non-current assets:					
Government and municipal bonds	2.5 %	2,161	2,161	2,161	2,129
Oscotech, Inc.	-	-	-	-	1,000
Litepharmtech, Inc.	-	-	-	-	1,000
		<u>2,161</u>	<u>2,161</u>	<u>2,161</u>	<u>4,129</u>
		<u>₩ 4,310</u>	<u>4,310</u>	<u>4,310</u>	<u>4,221</u>

- (*) The Company recorded an interest income of ₩20 million for the year ended December 31, 2008.

(c) Changes in unrealized gains

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

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

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8. Available-for-sale Securities, Continued

(c) Changes in unrealized gains, Continued

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

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

9. Equity Method Investment Securities

(a) Investments in companies accounted for using the equity method as of December 31, 2008 and 2007 were as follows:

In millions of Won, except percentage of ownership

<u>Company</u>	<u>Percentage of ownership</u>	<u>2008</u>		
		<u>Cost</u>	<u>Net assets</u>	<u>Balance at December 31, 2008</u>
Unlisted				
KGC Sales Co., Ltd.	100%	₩ <u>1,500</u>	<u>2,904</u>	<u>2,314</u>

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

In millions of Won, except percentage of ownership

<u>Company</u>	<u>Percentage of ownership</u>	<u>2007</u>		
		<u>Cost</u>	<u>Net assets</u>	<u>Balance at December 31, 2007</u>
Unlisted				
KGC Sales Co., Ltd.	100.00%	₩ 1,500	2,319	2,299
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. (*1)	99.99%	<u>33,670</u>	<u>33,670</u>	<u>33,670</u>
		₩ <u>35,170</u>	<u>35,989</u>	<u>35,969</u>

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

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9. Equity Method Investment Securities, Continued

- (b) Details of eliminated unrealized gains from inter-company transactions for the years ended December 31, 2008 and 2007 are summarized as follows:

<i>In millions of Won</i>	2008			
	<u>Beginning balance</u>	<u>Increase</u>	<u>Realized amount</u>	<u>Ending balance</u>
KGC Sales Co., Ltd.	₩ 20	590	(20)	590

<i>In millions of Won</i>	2007			
	<u>Beginning balance</u>	<u>Increase</u>	<u>Realized amount</u>	<u>Ending balance</u>
KGC Sales Co., Ltd.	₩ 149	20	(149)	20

- (c) Changes in the opening and closing balances of investments in companies accounted for using the equity method for the years ended December 31, 2008 and 2007 were as follows:

In millions of Won except percentage of ownership

Company	Percentage of ownership	2008			
		<u>Balance at January 1, 2008</u>	<u>Net Income</u>	<u>Other Decrease (*)</u>	<u>Balance at December 31, 2008</u>
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	99.99%	₩ 2,299	15	-	2,314
KGC Sales Co., Ltd.	100.00%	33,670	-	(33,670)	-
		₩ 35,969	15	(33,670)	2,314

(*) Other decrease was due to change of subsidiaries in consolidation.

In millions of Won except percentage of ownership

Company	Percentage of ownership	2007			
		<u>Balance at January 1, 2007</u>	<u>Net Income</u>	<u>Other Increase (*)</u>	<u>Balance at December 31, 2007</u>
KGC Sales Co., Ltd.	100.00%	₩ 1,111	1,188	-	2,299
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	99.99%	-	-	33,670	33,670
		₩ 1,111	1,188	33,670	35,969

(*) Other increase was due to reclassification from available-for-sale securities.

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9. Equity Method Investment Securities, Continued

- (d) Summarized financial information of equity method investment securities as of and for the year ended December 31, 2008 was as follows:

In millions of Won

<u>Affiliate</u>	<u>Total assets</u>	<u>Total liabilities</u>	<u>Sales</u>	<u>Net income</u>
KGC Sales Co., Ltd.	₩ 6,064	3,160	15,122	585

Summarized financial information of equity method investment securities as of and for the year ended December 31, 2007 was as follows:

In millions of Won

<u>Affiliate</u>	<u>Total assets</u>	<u>Total liabilities</u>	<u>Sales</u>	<u>Net income (loss)</u>
KGC Sales Co., Ltd.	₩ 6,739	4,420	18,067	1,059
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	37,973	4,303	-	(1,608)

10. Transactions and Balances with Related Companies

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

<u>Controlled subsidiary(*)</u>	<u>Ownership(%)</u>
Cosmo Tabacco Co., Ltd.	40.00%
Korea Tabacos do Brasil Ltda.	99.90%
Korea Islet Transplantation Institute, Inc.	48.25%
KGC Sales Co., Ltd.	100.00%
Yungjin Co., Ltd.	41.90%
KT&G Pars	99.99%
KT&G Rus L.L.C.	100%

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

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10. Transactions and Balances with Related Companies, Continued

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

(i) Revenue from sales and others

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
KGC Sales Co., Ltd.	₩ 13,065	14,196
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	-	1,866
KT&G Mongolia LLC.	-	1,457
KT&G USA, Inc.	-	1,694
KT&G Pars	1,521	-
	<u>₩ 14,586</u>	<u>19,213</u>

(ii) Purchases and other expenses

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Korea Tabacos do Brasil Ltda.	₩ 165	132
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	-	1,586
	<u>₩ 165</u>	<u>1,718</u>

(iii) Due from affiliates

<i>In millions of Won</i>	<u>2008</u>			<u>2007</u>		
	<u>Trade Accounts receivable</u>	<u>Other</u>	<u>Total</u>	<u>Trade Accounts receivable</u>	<u>Other</u>	<u>Total</u>
Company						
KT&G Mongolia LLC	₩ -	-	-	316	238	554
KT&G Pars	11	7,193	7,204	-	-	-
KT&G Rus L.L.C.	-	347	347	-	-	-
KGC Sales Co., Ltd.	1,747	-	1,747	3,158	-	3,158
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	-	-	-	1,127	-	1,127
Yungjin Health Food Co., Ltd.	-	-	-	4,310	-	4,310
	<u>₩ 1,758</u>	<u>7,540</u>	<u>9,298</u>	<u>8,911</u>	<u>238</u>	<u>9,149</u>

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10. Transactions and Balances with Related Companies, Continued

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Loans for employee housing and education	₩ 30,870	31,987
Loans to Employee Stock Ownership Association	28,388	37,803
Other	48,929	46,004
	<u>₩ 108,187</u>	<u>115,794</u>

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Short-term payroll	₩ 10,470	13,393
Post-retirement pay	9,086	5,132
	<u>₩ 19,556</u>	<u>18,525</u>

11. Advance Payments

The Company maintains a contract with the farmers under which they are to grow green ginseng and sell the ginseng to the Company once the product becomes six years old. As of December 31, 2008 and 2007, advance payments paid to the farmers in accordance with the contract are as follows:

In millions of Won

<u>Classification</u>	<u>Account</u>	<u>2008</u>	<u>2007</u>
Three-year old ginseng	Long-term advance payments	₩ 47,666	35,253
Four-year old ginseng	Long-term advance payments	35,236	31,749
Five-year old ginseng	Long-term advance payments	31,387	26,417
		114,289	93,419
Six-year old ginseng	Short-term advance payments	26,339	22,870
Total		<u>₩ 140,628</u>	<u>116,289</u>

KT&G CORPORATION AND SUBSIDIARIES
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December 31, 2008 and 2007

12. Property, Plant and Equipment

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

<i>In millions of Won</i>		<u>2008</u>	<u>2007</u>
Property, plant and equipment at cost	₩	2,603,045	2,470,193
Accumulated depreciation		(977,169)	(908,684)
Accumulated impairment losses		(1,125)	(2,220)
Property, plant and equipment, net	₩	<u>1,624,751</u>	<u>1,559,289</u>

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

<i>In millions of Won</i>		<u>January 1, 2008</u>	<u>Change of Subsidiaries</u>	<u>Acquisition</u>	<u>Disposal</u>	<u>Depreciation</u>	<u>Others (*2)</u>	<u>December 31, 2008</u>
Land	₩	431,728	2,526	1,304	(2,367)	-	16,705	449,896
Buildings		523,702	-	9,785	(3,367)	(29,139)	53,777	554,758
Structures		29,228	-	1,412	(145)	(2,674)	4,095	31,916
Machinery and equipment		390,703	-	14,229	(4,541)	(79,732)	94,961	415,620
Vehicles and other transportation equipment		3,354	-	802	(18)	(1,981)	71	2,228
Tools		13,329	-	3,993	(11)	(5,735)	3,380	14,956
Furniture and fixtures		82,448	106	27,395	(471)	(39,666)	3,278	73,090
Other tangible fixed assets		744	-	-	-	-	-	744
Construction-in-progress(*1)		84,053	25,834	148,971	-	-	(177,315)	81,543
	₩	<u>1,559,289</u>	<u>28,466</u>	<u>207,891</u>	<u>(10,920)</u>	<u>(158,927)</u>	<u>(1,048)</u>	<u>1,624,751</u>

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

(*2) Other changes for the year ended December 31, 2008 include the amount transferred to site for building lotting-out construction as part of inventories amounting to ₩5,970 million and the amount transferred from long-term advance payments amounting to ₩1,716 million.

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

<i>In millions of Won</i>		<u>January 1, 2007</u>	<u>Change of Subsidiaries/ Merger</u>	<u>Acquisition</u>	<u>Disposal</u>	<u>Depreciation</u>	<u>Other (*2)</u>	<u>December 31, 2007</u>
Land	₩	381,944	-	22,266	(13,592)	-	41,110	431,728
Buildings		499,947	-	7,683	(4,577)	(25,058)	45,707	523,702
Structures		28,557	25	1,822	(296)	(2,454)	1,574	29,228
Machinery and equipment		369,761	-	12,263	(2,554)	(76,365)	87,598	390,703
Vehicles and other transportation equipment		5,872	-	763	(225)	(3,131)	75	3,354
Tools		11,523	8	2,940	(28)	(5,163)	4,049	13,329
Furniture and fixtures		79,928	(52)	37,129	(131)	(38,696)	4,270	82,448
Other tangible fixed assets		605	-	139	-	-	-	744
Construction-in-progress(*1)		84,607	-	186,138	-	-	(186,692)	84,053
	₩	<u>1,462,744</u>	<u>(19)</u>	<u>271,143</u>	<u>(21,403)</u>	<u>(150,867)</u>	<u>(2,309)</u>	<u>1,559,289</u>

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12. Property, Plant and Equipment, Continued

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

(*2) Other changes for the year ended December 31, 2007 include losses on impairment of property, plant and equipment amounting to ₩2,179 million and the amount transferred to intangible assets.

13. Officially Declared Value of Land

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

	2008		2007	
	Book value	Declared value	Book value	Declared value
<i>In millions of Won</i>				
Land	₩ 449,896	1,481,431	431,728	1,373,374
Sites for building lotting-out construction	12,728	50,555	13,204	40,356
	₩ <u>462,624</u>	<u>1,531,986</u>	<u>444,932</u>	<u>1,413,730</u>

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 ₩1,300,423 million as of December 31, 2008 with DongBu Insurance Co., Ltd. and others. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

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15. Pledged Assets

The following assets were pledged as collateral for the Company's short-term and long-term borrowings as of December 31, 2008:

In millions of Won

Asset	Lender	Type of borrowings	Borrowing amount	Book value	Collateralized amount
Land, Buildings and Structures	Hana Bank	Short-term	₩ 23,255	34,223	36,400
	Hana Bank	Long-term (including current portion)	2,754		
	Hana Bank	Short-term	1,200	1,650	
	Korea Exchange Bank	Short-term			
			<u>7,000</u>		<u>13,000</u>
			<u>₩ 34,209</u>	<u>34,223</u>	<u>51,050</u>

16. Goodwill

Changes in goodwill for the years ended December 31, 2008 and 2007 were as follows:

In millions of Won

	2008	2007
Beginning balance	₩ 4,007	6,977
Amortization	<u>(2,969)</u>	<u>(2,970)</u>
Ending balance	<u>₩ 1,038</u>	<u>4,007</u>

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17. Intangible Assets

Changes in intangible assets for the years ended December 31, 2008 and 2007 were as follows:

		2008		
<i>In millions of Won</i>		Industrial property rights	Other intangible assets	Total
Net balance at beginning of period	₩	2,224	2,428	4,652
Increases		130	517	647
Amortization		(836)	(902)	(1,738)
Disposal		-	(23)	(23)
Other(*)		199	167	366
Net balance at end of period	₩	<u>1,717</u>	<u>2,187</u>	<u>3,904</u>
		2007		
<i>In millions of Won</i>		Industrial property rights	Other intangible assets	Total
Net balance at beginning of period	₩	3,714	1,557	5,271
Increases		425	1,575	2,000
Merger		-	4	4
Amortization and impairment		(1,915)	(708)	(2,623)
Net balance at end of period	₩	<u>2,224</u>	<u>2,428</u>	<u>4,652</u>

(*) Other changes for the year ended December 31, 2008 include the amount of ₩159 million due to change in subsidiaries and transferred from construction-in-progress amounting to ₩199 million.

18. Other Non-current Assets

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

<i>In millions of Won</i>	2008	2007
Long-term financial instruments (note 4)	₩ 6	44
Long-term trade account receivable, net of allowance for doubtful accounts of nil in 2008 and ₩7,253 in 2007	-	84
Other investment assets, net of allowance for doubtful accounts of nil in 2008 and ₩2,912 in 2007	3,776	2,578
Long-term other receivables, net of allowance for doubtful accounts of ₩6 in 2008 and ₩10 in 2007	<u>555</u>	<u>1,017</u>
	<u>₩ 4,337</u>	<u>3,723</u>

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19. Other Current Liabilities

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Withholdings	₩ 14,321	11,763
Unearned income	379	89
Withholding guarantee deposits received	45	102
Provision for mileage program	7,764	5,108
Derivatives (note 39)	2,699	25
Current portion of long-term borrowings (notes 15 and 21)	<u>280</u>	<u>210</u>
	₩ <u>25,488</u>	<u>17,297</u>

20. Short-term Borrowings

Short-term borrowings as of December 31, 2008 and 2007 are summarized as follows:

<u>Type of borrowings</u>	<u>Lender</u>	<u>Interest rate per annum</u>	<u>Amount</u>	
			<u>2008</u>	<u>2007</u>
Loans for working capital	Hana Bank	7.81~7.90%	₩ 12,650	13,000
	Hana Bank	8.19%	8,000	8,000
	Hana Bank	6.67%	1,200	1,200
	Hana Bank	9.77%	1,500	-
Commercial paper	Hana Bank	9.06%	1,105	-
	Tong Yang Securities Inc.	9.00%	3,000	-
	SK Securities Co., Ltd.	6.37%	-	5,338
	Woori Investment & Securities Co., Ltd.	10.00%	-	10,000
Loans for working capital	Korea Exchange Bank	7.88~8.80%	7,000	-
	Korea Exchange Bank	7.48%	20,000	-
Loans for foreign currency working capital	Standard Chartered First Bank Korea Ltd.	1Y LIBOR +0.80%	-	559
			₩ <u>54,455</u>	<u>38,097</u>

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21. Long-term Borrowings

(a) Long-term borrowings as of December 31, 2008 and 2007 are summarized as follows:

In millions of Won

<u>Type of borrowings</u>	<u>Lender</u>	<u>Maturity date</u>	<u>Interest rate per annum</u>	<u>Amount</u>	
				<u>2008</u>	<u>2007</u>
Energy Rationalization Fund	Hana Bank	March 15, 2013	4.25%	₩ 1,192	1,402
Environmental Management Corporation Fund	Hana Bank	March 31, 2017	5.32%	1,562	1,541
				2,754	2,943
Less current portion				(280)	(210)
				₩ 2,474	2,733

(b) Repayment schedule for the Company's long-term borrowings as of December 31, 2008 is as follows:

In millions of Won

<u>Year ending December 31,</u>	<u>Amount</u>
2009	₩ 280
2010	448
2011	504
2012	504
thereafter	1,018
	₩ 2,754

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22. Retirement and Severance Benefits

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Estimated retirement and severance benefits accrual at beginning of year	₩ 219,494	208,923
Provision for retirement and severance benefits	55,714	40,335
Transferred to unearned stock compensation	(2,295)	-
Payments (*1)	<u>(110,175)</u>	<u>(29,764)</u>
Estimated retirement and severance benefits accrual at end of year	162,738	219,494
Contribution to the National Pension Fund	(262)	(295)
Retirement pension plan asset (*2)	(84,959)	-
Deposit for severance benefits trust	<u>(18,269)</u>	<u>(132,807)</u>
Net balance at end of year	₩ <u>59,248</u>	<u>86,392</u>

(*1) Compensations paid with treasury stock amounting to ₩2,430 million and ₩8,247 million for the years ended December 31, 2008 and 2007 respectively, were included.

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

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

The Company maintains employees' severance benefit trust arrangements with Samsung Life Insurance Co., Ltd. and others. Under these arrangements, the Company has made a deposit in the aggregate amount equal to 11.2% and 60.5% of the reserve balances of retirement and severance benefits as of December 31, 2008 and 2007, 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.

The Company introduced a defined benefit pension plan in 2008, under this program the Company has made a deposit on retirement pension plan asset equal to 52.2% of the reserve balance of retirement and severance benefits on Hyundai Securities Co., Ltd and others as of December 31, 2008.

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23. Assets and Liabilities Denominated in Foreign Currencies

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

In millions of Won

*In thousands of US dollars, JPY, Euro,
 HKD, CNY and NTD*

		Foreign currency		Korean Won equivalent	
		2008	2007	2008	2007
Assets:					
Cash and cash equivalents	USD	1,735	9,984	₩ 2,180	9,367
	JPY	2,010	34,467	28	287
	NTD	3,859	1,495	154	43
	CNY	38	-	7	-
Trade accounts receivable	USD	214,060	166,988	269,181	156,668
	EUR	746	816	1,325	1,127
	JPY	93,652	250,854	1,305	2,090
	NTD	3,291	-	132	-
Other receivables	USD	3,259	259	4,098	243
Long-term deposits in the escrow fund	USD	<u>87,683</u>	<u>71,022</u>	<u>110,261</u>	<u>66,633</u>
Total	USD	306,737	248,253	₩ 385,720	232,911
	EUR	746	816	1,325	1,127
	JPY	95,662	285,321	1,333	2,377
	NTD	7,150	1,495	286	43
	CNY	<u>38</u>	<u>-</u>	<u>7</u>	<u>-</u>
				₩ <u>388,671</u>	<u>236,458</u>
Liabilities:					
Trade accounts payable	USD	1,126	1,351	₩ 1,417	1,267
	EUR	4,162	2,535	7,393	3,502
	JPY	<u>-</u>	<u>2,613</u>	<u>-</u>	<u>22</u>
				₩ <u>8,810</u>	<u>4,791</u>

24. Commitments and Contingencies

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

As of December 31, 2008, tobacco lawsuits claiming damages of ₩759 million were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligation to notify smokers of the potential health hazards of smoking. Additionally, the Company is involved in 20 lawsuits and claims for alleged damages totaling ₩19,297 million as of December 31, 2008. The amount of the liability the Company may ultimately have with respect to the litigation cannot be reasonably estimated as of December 31, 2008.

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24. Commitments and Contingencies, Continued

As of December 31, 2008, the Company has provided the National Agricultural Cooperative Federation ("NACF") and other banks, with guarantees in the aggregate amount of ₩40,105 million for the customers who made a financing agreement with these lenders.

As of December 31, 2008, the Company has entered into Letter of Credit agreements with NACF and several financial institutions in the amount of USD 104,300 thousand.

As of December 31, 2008, the Company's trade accounts receivable from the export of cigarettes was insured against nonpayment up to USD 34,400 thousand by export guaranty insurance with the Korea Export Insurance Corporation.

As of December 31, 2008, the Company has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries up to USD 90,000 thousand by Korea Exchange Bank and other.

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

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

As of December 31, 2008, the Company maintains a contract with the farmers who grow nine-year old green ginseng for purchase volume guarantees and recorded advance payments to the farmers in accordance with the contract amounted to ₩140,628 million.

Decided upon the board of director meeting on November 3, 2006, the Company determined to dispose the land located in Pyeongtaek-si Gyeonggi-do for the purpose of improving the financial structure and investment in property. The Company entered into a contract to sell the land for ₩20,000 million (including removal cost of production equipment of ₩6,000 million). The transacting party may terminate the contract if the land is not included in area for development by Pyeongtaek city.

As of December 31, 2008, the Company has entered into note discounting contracts with Hana Bank and others with the aggregate of lines of credit of ₩19,000 million, and the amount discounted but not due as of December 31, 2008 totaled ₩12,053 million.

As of December 31, 2008, the Company provided 2 blank notes and 14 notes amounting to ₩17,200 million and 5 blank checks to Woori Investment & Securities Co., Ltd. and others as collateral for its short-term and long-term borrowings and trade agreements. The Company is making legal process for 1 lost note provided as collateral as of December 31, 2008.

25. Capital Adjustments

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

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

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26. Accumulated Other Comprehensive Income

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Unrealized gain on valuation of available-for-sale securities	₩ 27,738	2,100
Unrealized gain on valuation of equity method investment securities	132	1,035
Gain (loss) on overseas operations translation	<u>2,802</u>	<u>(639)</u>
	₩ <u>30,672</u>	<u>2,496</u>

27. Retained Earnings

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Legal reserve	₩ 602,937	602,937
Reserve for business expansion	698,881	698,881
Reserve for business rationalization	12,851	12,851
Reserve for research and human resource development	30,000	45,000
Reserve for loss on reissuance of treasury stock	26,646	26,646
Other appropriations	420,000	350,000
Unappropriated retained earnings at end of period	<u>515,615</u>	<u>398,421</u>
	₩ <u>2,306,930</u>	<u>2,134,736</u>

(a) Legal Reserve

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

(b) Reserve for Business Expansion

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

(c) Reserve for Business Rationalization

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

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

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27. Retained Earnings, Continued

(d) Other Reserves

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

28. Building Lotting-out Construction Contracts

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

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

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

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

28. Building Lotting-out Construction Contracts, Continued

(c) Cost of installment sales of housing units as of December 31, 2008 are summarized as follows:

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

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29. Selling, General and Administrative Expenses

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Salaries	₩ 228,530	216,934
Provision for severance benefits	36,609	26,234
Welfare	26,602	34,783
Travel	9,461	8,474
Communications	5,063	4,737
Utilities	6,294	6,230
Taxes and dues	24,412	21,028
Supplies	4,981	3,503
Uniforms	212	162
Rent	13,246	8,804
Depreciation	57,468	56,243
Amortization	4,684	4,508
Repairs and maintenance	5,941	10,509
Vehicles	9,463	7,539
Insurance	1,224	1,309
Commissions	90,958	86,285
Transportation and warehousing	35,406	30,458
Entertainment	1,487	2,509
Conferences	6,250	6,917
Advertising	201,260	172,050
Training	9,371	9,461
Prizes and rewards	5,288	2,108
Cooperation	944	797
Normal research and development	21,861	22,834
Sample	27	16
Bad debts	11,578	7,242
Other	1,292	1,652
	<u>₩ 819,912</u>	<u>753,326</u>

30. Added Value

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Wages and salaries	₩ 395,286	375,955
Provision for severance benefits	55,714	40,335
Employee welfare	47,991	55,521
Rent	23,427	16,962
Depreciation	158,927	150,867
Taxes and dues	28,381	24,733

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31. Employee Welfare and Contributions to Society

For employee welfare, the Company maintains a refectory, infirmary, athletic facilities, scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spent for the years ended December 31, 2008 and 2007 were estimated at ₩47,991 million and ₩55,521 million, respectively.

The Company donated ₩34,092 million and ₩30,293 million to KT&G Social Welfare Foundation and others for the years ended December 31, 2008 and 2007, respectively.

32. Income Taxes

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

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

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

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

<i>In millions of Won</i>		<u>2008</u>	<u>2007</u>
Current income tax expense	₩	337,325	324,972
Deferred income tax expense		18,249	9,766
Income tax expense charged directly to stockholders' equity		<u>(9,169)</u>	<u>(43,344)</u>
Income tax expense	₩	<u>346,405</u>	<u>291,394</u>

(c) Deferred tax assets and liabilities are measured using the tax rate to be applied for the year in which temporary differences are expected to be realized, and the change in deferred tax assets (liabilities) due to the change in the income tax rate amounting to ₩27,490 million of which ₩261 million was recognized directly to equity and ₩27,229 million was recognized in current income tax expense.

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32. Income Taxes, Continued

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Expense for income taxes at normal tax rates ₩	379,901	296,839
Tax effects of permanent differences	(12,181)	(1,350)
Tax credit	(6,272)	(10,206)
Changes in valuation allowances for deferred income tax assets (liabilities) arisen from equity in income of affiliates	10,074	6,026
Effect from change in tax rate	(29,210)	-
Additional income taxes for prior period (Refund of prior year's income taxes)	3,939	991
Other	154	(906)
Income tax expense ₩	<u>346,405</u>	<u>291,394</u>

- (e) The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 28.03% and 31.07% for the years ended December 31, 2008 and 2007.
- (f) The Company did not recognize a deferred tax liability in the amount of ₩31,999 million and ₩58,200 million arising from the taxable temporary differences associated with affiliates as of December 31, 2008 and 2007, respectively, since non-taxable dividend income is excluded from equity in income of affiliates in the calculation of deferred tax liabilities. Also the Company did not recognize a deferred tax liability in the amount of ₩5,207 million and ₩3,450 million arising from the taxable temporary differences as of December 31, 2008 and 2007, respectively.
- (g) The Company did not recognize a deferred tax asset in the amount of ₩43,919 million and ₩31,749 million arising from the deductible temporary differences associated with affiliates as of December 31, 2008 and 2007, respectively, since there is a remote possibility that the Company will dispose of its investments in affiliates in the foreseeable future. In addition, the Company did not recognize a deferred tax asset in the amount of ₩38,899 million and ₩56,112 million arising from other deductible temporary differences as of December 31, 2008 and 2007, respectively.
- (h) Deferred tax assets and liabilities that were directly charged or credited to accumulated other comprehensive income for the years ended December 31, 2008 and 2007 were as follows:

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

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32. Income Taxes, Continued

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

<i>In millions of Won</i>		Temporary differences at December 31, 2008	Deferred tax assets (liabilities)	
			Current	Non-current
Assets:				
	Provision for retirement and severance benefits	₩ 130,740	-	25,492
	Loss on valuation of inventories	9,518	137	-
	Depreciation	15,934	-	3,540
	Bad debt	25,211	4,963	-
	Impairment losses on property, plant and equipment	3,733	-	293
	Impairment losses on available-for-sale security	8,089	-	1,384
	Impairment losses on intangible assets	2,245	-	315
	Accrued expense	4,883	1,182	-
	Donation in excess of tax limit	35,564	8,606	-
	Other	23,101	3,736	820
		<u>259,018</u>	<u>18,624</u>	<u>31,844</u>
Liabilities:				
	Deposit for severance benefits trust	(103,099)	-	(22,110)
	Reserve for research and human resource development	(24,054)	-	(5,291)
	Equity method investment securities	(525,859)	-	(118,176)
	Reserve for losses on reissuance of treasury stock	(26,646)	-	(5,862)
	Available-for-sale securities	(35,562)	-	(7,824)
	Treasury stock	(38,930)	-	(8,564)
	Gain on foreign currency translation	(24,948)	(6,055)	-
		<u>(779,098)</u>	<u>(6,055)</u>	<u>(167,827)</u>
	Unused tax losses	5,470	-	-
	Net differed tax asset(liability)	<u>₩ (514,610)</u>	<u>12,569</u>	<u>(135,983)</u>

(*) The carry forward of unused tax losses in respect of which deferred tax assets in the amount of ₩4,020 million and unused tax credit in the amount of ₩786 million have not been recognized as of December 31, 2008 due to the remote likelihood of utilization.

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33. Earnings Per Share

(a) Basic earnings per share

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Controlling interest in net income per accompanying consolidated statements of income	₩ 892,396	662,606
Weighted-average number of shares outstanding	<u>130,140,446</u>	<u>132,442,442</u>
Basic earnings per share in Korean Won	<u>₩ 6,857</u>	<u>5,003</u>

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

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

34. Share-based Payment

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

<i>In Won</i>	<u>Method of settlement</u>	<u>Optional share-based payment</u>
Type		Severance payment based on performance by share grant
Grant date		1 st : March 1, 2007 2 nd : January 1, 2008 3 rd : March 15, 2008 4 th : April 1, 2008
Number of executives		46
Number of shares granted (*1)		155,519
Vesting condition		Service condition : 1~3 years Non-market performance condition (*2)
Share price at the grant date		₩ 56,534~72,884
Severance payment		₩ 6,953,733,254 (The average exercise price: 44,713)
Expiration		0.916~3 years
The risk-free interest rate		4.86%~5.68%
Volatility		0.092~0.147

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34. Share-based Payment, Continued

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

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

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Share-based payment expense recognized		
retirement and severance payment	₩ 9,113	1,370
Remaining expense to be recognized in the future years	1,769	4,109

35. Comprehensive Income

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

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Net income	₩ 889,355	646,405
Change in fair value of available-for-sale securities, net of tax effect of ₩(7,027) in 2008 and ₩5,245 in 2007	25,637	(13,829)
Increase in unrealized gain on valuation of equity method investments, net of tax effect of nil in 2008 and ₩275 in 2007	-	26
Change in translation adjustments, net of tax effect of ₩(483) in 2008 and nil in 2007	3,441	508
Other	(903)	-
Comprehensive income	<u>₩ 917,530</u>	<u>633,110</u>
Controlling company's interest	₩ 920,571	649,311
Minority interest	<u>(3,041)</u>	<u>(16,201)</u>

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36. 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 operations.
- (b) Information on each operating segment as of and for the year ended December 31, 2008 was as follows:

<i>In millions of Won</i>	Tobacco	Ginseng	Other operations	Consolidation adjustment	Total
Sales	₩ 2,532,317	656,781	241,357	(66,924)	3,363,531
Operating income	970,004	199,923	1,663	(3,630)	1,167,960
Total assets	4,449,722	764,197	131,937	(773,668)	4,572,188

- (c) Information on each operating segment as of and for the year ended December 31, 2007 was as follows:

<i>In millions of Won</i>	Tobacco	Ginseng	Other operations	Consolidation adjustment	Total
Sales	₩ 2,406,293	544,877	129,475	(34,261)	3,046,384
Operating income (loss)	815,082	162,550	(7,435)	9,832	980,029
Total assets	3,988,125	640,904	108,110	(603,037)	4,134,102

37. Non-cash Investing and Financing Activities

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

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

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38. Consolidated Net Income and Net Income in Minority Interest

Consolidated net income and net income in minority interest for the year ended December 31, 2008 was as follows:

In millions of Won, except percentage of ownership

Company	Adjusted net income			Minority interest in net income		Controlling interest in net income		
	Non-consolidated net income (loss)	Adjustments (*)	Adjusted net income (loss)	Equity ownership of minority interest(%)	Net income in minority interest	Net income (loss) before goodwill amortization	Goodwill amortization	Controlling interest in net income (loss)
KT&G	₩ 894,290	(133,015)	761,275	-	-	761,275	2,969	758,306
KGC	145,046	(2,252)	142,794	-	-	142,794	-	142,794
KGHK	352	-	352	0.00%	-	352	-	352
TAI	579	(120)	459	-	-	459	-	459
YJPI	(6,734)	(100)	(6,834)	44.50%	(3,041)	(3,793)	-	(3,793)
KTMST	(5,722)	-	(5,722)	0.01%	-	(5,722)	-	(5,722)
	₩ 1,027,811	(135,487)	892,324		(3,041)	895,365	2,969	892,396

(*) Adjustments represent reversal of equity income (loss) of subsidiaries and unrealized income from intercompany transactions.

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39. Derivative Instruments

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

In Won and thousands of US dollars

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

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

In millions of Won

	2008	2007
Currency forward	₩ -	(25)
Currency option	(2,699)	-
	₩ (2,699)	(25)

(*) All these gain and loss on valuation of derivative instruments was charged to net income.

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

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

(a) Planning and applying K-IFRS

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

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

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

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

(c) Effects on the Affiliated Companies

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

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

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

<i>In millions of Won</i>	<u>Total assets</u>	<u>Total liabilities</u>	<u>Shareholder's Equity</u>
K-GAAP	₩ 4,134,102	970,875	3,163,227
Adjustments:			
Revenue recognition for construction contracts	12,623	19,172	(6,549)
Actuarial valuation on severance and retirement benefit	(2,092)	(18,392)	16,300
Employee benefit – annual leave and bonus payment	5,966	85,703	(79,737)
Offsetting financial asset and liability	164,376	164,376	-
Eliminating financial assets in respect to consumer credit	47,388	47,388	-
Bad debts and impairment on financial assets	10,497	-	10,497
Accounts for membership rights and others	(959)	-	(959)
Changes in the depreciation method and useful life of tangible assets	4,037	-	4,037
Changes in the scope of subsidiaries and associates and others	21,150	5,686	15,464
Effect on income tax	15,450	(2,568)	18,018
Total adjustments	<u>278,436</u>	<u>301,365</u>	<u>(22,929)</u>
K-IFRS	₩ <u>4,412,538</u>	<u>1,272,240</u>	<u>3,140,298</u>

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

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

<i>In millions of Won</i>	<u>Total assets</u>	<u>Total liabilities</u>	<u>Share- holder's Equity</u>	<u>Net income (loss)</u>
K-GAAP	₩ 4,572,188	1,016,057	3,556,131	889,355
Adjustments:				
Revenue recognition for construction contracts	37,473	67,047	(29,574)	(23,025)
Actuarial valuation on severance and retirement benefit	2,301	12,934	(10,633)	17,530
Employee benefit – annual leave and bonus payment	3,890	87,951	(84,061)	(4,324)
Offsetting financial asset and liability	201,774	201,774	-	-
Eliminating financial assets in respect to consumer credit	49,657	49,657	-	-
Bad debts and losses on financial assets	22,732	-	22,732	12,235
Accounts for membership rights and others	(1,029)	-	(1,029)	(70)
Changes in the depreciation method and useful life of tangible assets	8,841	-	8,841	4,804
Amortization cost method for financial instruments	38	(9)	47	47
Changes in the scope of subsidiaries and associates and others	21,781	8,015	13,766	(1,901)
Effect on income tax	9,489	(12,360)	21,849	(5,615)
Total adjustments	<u>356,947</u>	<u>415,009</u>	<u>(58,062)</u>	<u>(319)</u>
K-IFRS	₩ <u>4,929,135</u>	<u>1,431,066</u>	<u>3,498,069</u>	<u>889,036</u>

The effects on the Company's financial position and result of operation mentioned above may change.