

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Financial Statements

(Unaudited)

June 30, 2007 and 2006

(With Independent Accountants' Review Report Thereon)

Independent Accountants' Report

Based on a report originally issued in Korean

The Board of Directors and Stockholders
KT&G Corporation:

We have reviewed the accompanying consolidated balance sheets of KT&G Corporation and subsidiaries (collectively, the "Company") as of June 30, 2007, and the related consolidated statements of changes in stockholders' equity for the six-month periods and consolidated statements of income and cash flows for the three-month and six-month periods ended June 30, 2007 and 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these consolidated financial statements based on our reviews.

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

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

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

The accompanying consolidated financial statements as of and for the three-month and six-month periods ended June 30, 2007 have been translated into United States dollars solely for the convenience of the reader. We have reviewed the translation and, in our opinion, the consolidated financial statements expressed in Korean Won have been translated into United States dollars on the basis set forth in note 2 to the consolidated financial statements.

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

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

As discussed in note 26 to the consolidated financial statements, the Company has entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund with the target set at ₩410,000 million by 2008 for the purpose of stabilizing tobacco production. Under the agreement, the Company is obligated to make up the deficiency, should the fund fall short of the target. The Company estimates the deficiency at the end of each period and provides for a provision to fully fund the tobacco production stabilization program by 2008. The provision for the fund made by the Company amounted to ₩8,935 million and ₩9,041 million for the six-month periods ended June 30, 2007 and 2006, respectively, and the reserve for the fund as of June 30, 2007 and December 31, 2006 amounted to ₩83,419 million and ₩74,484 million, respectively.

As discussed in note 25 to the consolidated financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩1,282 million for the effects of smoking. According to the Company's management, the final outcome of these lawsuits cannot be predicted at present. Accordingly, no provisions have been made in the accompanying consolidated financial statements.

As discussed in notes 11 and 25 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 June 30, 2007 and December 31, 2006, the balance of advance payments paid to the farmers in accordance with the contract amounted to ₩174,069 million and ₩107,848 million, respectively.

Seoul, Korea
August 4, 2007

This report is effective as of August 4, 2007, the review report date. Certain subsequent events or circumstances, which may occur between the review report date and the time of reading this report, could have a material impact on the accompanying consolidated financial statements and notes thereto. Accordingly, the readers of the review report should understand that there is a possibility that the above review report may have to be revised to reflect the impact of such subsequent events or circumstances, if any.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 2007 and December 31, 2006

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

Assets	(Unaudited) 2007		(Audited) 2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Current assets:			
Cash and cash equivalents (note 21)	₩ 368,641	\$ 397,757	₩ 201,869
Short-term financial instruments	1,000	1,079	1,000
Trade accounts receivable, net of allowance for doubtful accounts of ₩29,439 in 2007 and ₩39,306 in 2006 (notes 4, 9, 21 and 25)	339,309	366,108	355,029
Inventories (notes 5 and 14)	1,101,072	1,188,036	1,299,769
Current portion of long-term loans, net of allowance for doubtful accounts of ₩1,064 in 2007 and ₩1,000 in 2006 and present value discount of ₩4,976 in 2007 and ₩11,416 in 2006 (note 10)	105,605	113,946	99,647
Current portion of deferred income tax assets (note 28)	8,090	8,729	8,226
Other current assets (note 6)	<u>173,987</u>	<u>187,729</u>	<u>83,405</u>
Total current assets	2,097,704	2,263,384	2,048,945
Available-for-sale securities (note 7)	292,648	315,762	71,156
Equity method investment securities (note 8)	1,361	1,468	1,111
Long-term loans to cooperative federations (note 10)	2,038	2,199	2,014
Long-term loans to employees	66,947	72,235	61,408
Long-term loans to affiliates (note 9)	238	257	1,487
Guarantee deposits	38,955	42,030	42,510
Guarantee deposits for membership	25,367	27,371	21,502
Long-term deposit in Escrow Fund (notes 21 and 25)	59,744	64,463	45,611
Other investment assets, net of allowance for doubtful accounts of ₩2,912 in 2007 and ₩1,507 in 2006	5,089	5,491	5,716
Property, plant and equipment, at cost (notes 12, 13 and 14)	2,317,618	2,500,667	2,239,932
Less accumulated depreciation and impairment losses	<u>(838,275)</u>	<u>(904,483)</u>	<u>(777,188)</u>
Net property, plant and equipment	1,479,343	1,596,184	1,462,744
Intangible assets	10,900	11,761	12,248
Other assets (note 16)	<u>120,243</u>	<u>129,741</u>	<u>80,674</u>
Total assets	₩ <u>4,200,577</u>	\$ <u>4,532,345</u>	₩ <u>3,857,126</u>

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets, Continued

June 30, 2007 and December 31, 2006

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

<u>Liabilities and Stockholders' Equity</u>	(Unaudited)		(Audited)
	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Current liabilities:			
Trade accounts payable (notes 9 and 21)	₩ 27,791	\$ 29,986	₩ 14,896
Short-term borrowings (notes 18, 21 and 25)	80,946	87,339	80,786
Advance receipts	9,081	9,798	7,999
Value added tax payable	138,165	149,077	128,948
Accrued expenses	15,483	16,707	10,519
Other payables	30,690	33,114	30,548
Tobacco excise tax and other	612,381	660,748	55,388
Income taxes payable	140,912	152,041	135,654
Other current liabilities (note 17)	<u>18,650</u>	<u>20,123</u>	<u>18,383</u>
Total current liabilities	1,074,099	1,158,933	483,121
Long-term borrowings (notes 19 and 25)	2,458	2,652	1,402
Retirement and severance benefits (note 20)	100,155	108,065	99,506
Guarantee deposits received	23,969	25,863	27,525
Deferred income tax liabilities (note 28)	111,373	120,169	103,528
Reserve for sales returns	1,030	1,111	1,797
Reserve for Tobacco Production Stabilization Fund (note 27)	<u>83,419</u>	<u>90,008</u>	<u>74,484</u>
Total liabilities	<u>1,396,503</u>	<u>1,506,801</u>	<u>791,363</u>
Stockholders' equity			
Common stock of ₩5,000 par value (note 1 and 22):			
Authorized – 800,000,000 shares			
Issued – 143,442,497 shares			
Outstanding – 129,371,548 shares in 2007 and 133,213,315 shares in 2006	954,959	1,030,383	954,959
Capital surplus	339,956	366,806	335,350
Capital adjustments (note 22)	(318,573)	(343,734)	(321,904)
Accumulated other comprehensive income (note 23)	19,631	21,181	15,791
Retained earnings (note 24)	1,800,160	1,942,339	2,061,349
Minority interest in consolidated subsidiaries	<u>7,941</u>	<u>8,569</u>	<u>20,218</u>
Total stockholders' equity	2,804,074	3,025,544	3,065,763
Commitments and contingencies (note 25)			
Total liabilities and stockholders' equity	₩ <u>4,200,577</u>	\$ <u>4,532,345</u>	₩ <u>3,857,126</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income

Six-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Sales (notes 9, 27 and 34)	₩ 1,461,458	\$ 1,576,886	₩ 1,315,278
Cost of sales (notes 9, 27, 31 and 32)	<u>639,375</u>	<u>689,874</u>	<u>607,001</u>
Gross profit	822,083	887,012	708,277
Selling, general and administrative expenses (notes 31, 32 and 33)	<u>367,345</u>	<u>396,358</u>	<u>322,917</u>
Operating income	<u>454,738</u>	<u>490,654</u>	<u>385,360</u>
Other income (expense):			
Interest income	19,821	21,386	21,466
Interest expense	(2,431)	(2,623)	(1,752)
Loss on foreign currency transactions, net	(711)	(767)	(5,207)
Other bad debts expense	(410)	(442)	(351)
Loss on impairment of available-for-sale securities	(2,150)	(2,320)	(2,364)
Gain on valuation of equity method investment securities	250	270	329
Gain on sale of equity method investment securities	-	-	17,428
Gain on sale of property, plant and equipment, net	4,980	5,373	1,501
Loss on impairment of property, plant and equipment	-	-	(686)
Gain on conversion of convertible bonds	-	-	1,876
Donations (note 32)	(6,946)	(7,495)	(41,597)
Provision for Tobacco Production Stabilization Fund (note 26)	(8,935)	(9,642)	(9,042)
Other, net	<u>4,459</u>	<u>4,813</u>	<u>(305)</u>
	<u>7,927</u>	<u>8,553</u>	<u>(18,704)</u>
Income before income taxes and minority interest	462,665	499,207	366,656
Income taxes (note 28)	<u>146,840</u>	<u>158,438</u>	<u>116,758</u>
Income before minority interest	315,825	340,769	249,898
Minority interest in losses of consolidated subsidiaries	<u>(12,204)</u>	<u>(13,168)</u>	<u>(1,662)</u>
Net income	₩ <u>328,029</u>	\$ <u>353,937</u>	₩ <u>251,560</u>
Basic earnings per share in Korean Won and U.S. dollars (note 29)	₩ <u>2,471</u>	\$ <u>2,957</u>	₩ <u>1,739</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income

Three-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Sales (notes 9,27 and 34)	₩ 797,644	\$ 860,643	₩ 739,045
Cost of sales (notes 9,27,31 and 32)	<u>342,231</u>	<u>369,261</u>	<u>335,088</u>
Gross profit	455,413	491,382	403,957
Selling, general and administrative expenses (note 31,32 and 33)	<u>197,809</u>	<u>213,432</u>	<u>169,053</u>
Operating income	<u>257,604</u>	<u>277,950</u>	<u>234,904</u>
Other income (expense):			
Interest income	9,415	10,159	11,365
Interest expense	(1,210)	(1,306)	(931)
Loss on foreign currency transactions, net	(1,937)	(2,090)	(1,153)
Other bad debts expense	(46)	(50)	(712)
Loss on impairment of available-for-sale securities	(2,150)	(2,320)	(763)
Gain (loss) on valuation of equity method investment securities	(26)	(28)	2,071
Gain on sale of equity method investment securities	-	-	17,428
Gain on sale of property, plant and equipment, net	1,468	1,584	2,073
Loss on impairment of property, plant and equipment	-	-	(686)
Donations	(476)	(514)	(29,100)
Provision for Tobacco Production Stabilization Fund (note 26)	(4,634)	(5,000)	(4,521)
Other, net	<u>11,073</u>	<u>11,948</u>	<u>(1,071)</u>
	<u>11,477</u>	<u>12,383</u>	<u>(6,000)</u>
Income before income taxes and minority interest	269,081	290,333	228,904
Income taxes (note 28)	<u>81,847</u>	<u>88,311</u>	<u>75,140</u>
Income before minority interest	187,234	202,022	153,764
Minority interest in losses of consolidated subsidiaries	<u>(11,282)</u>	<u>(12,173)</u>	<u>(1,039)</u>
Net income	<u>₩ 198,516</u>	<u>\$ 214,195</u>	<u>₩ 154,803</u>
Basic earnings per share in Korean Won and U.S. dollars (note 29)	<u>₩ 1,501</u>	<u>\$ 1,620</u>	<u>₩ 1,074</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Six-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from operating activities:			
Net income	₩ 328,029	\$ 353,937	₩ 251,560
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	75,510	81,474	65,953
Amortization of present value discounts	(6,484)	(6,996)	(5,753)
Loss (gain) on valuation of inventories, net	(9,630)	(10,391)	14,759
Bad debts expense	21,985	23,721	1,138
Loss on impairment of available-for-sale securities	2,150	2,320	2,364
Gain on valuation of equity method investment securities	(250)	(270)	(329)
Gain on sale of equity method investment securities	-	-	(17,428)
Loss on foreign currency transactions, net	517	558	760
Other bad debts expense	410	442	351
Provision for retirement and severance benefits	16,487	17,789	14,755
Gain on sale of property, plant and equipment, net	(4,980)	(5,373)	(1,501)
Provision for Tobacco Production Stabilization Fund	8,936	9,642	9,042
Gain on conversion of convertible bonds	-	-	(1,876)
Deferred income tax liabilities	6,475	6,986	6,072
Minority interest in losses of consolidated subsidiaries	(12,205)	(13,169)	(1,662)
Decrease (increase) in assets:			
Trade accounts receivable	(1,862)	(2,010)	695
Other receivables	(3,115)	(3,361)	(2,242)
Accrued income	(1,351)	(1,458)	2,214
Advance payments	(81,645)	(88,093)	(56,027)
Prepaid expenses	(9,589)	(10,346)	(6,692)
Inventories	189,247	204,194	200,331
Long-term advance payments	(33,934)	(36,614)	(31,554)
Increase (decrease) in liabilities:			
Trade accounts payable	5,070	5,470	(19,973)
Other payables	(653)	(705)	3,907
Advance receipts	1,083	1,169	(341)
Withholdings	783	845	(9,093)
Value added tax payable	9,217	9,945	2,464
Accrued expenses	7,870	8,492	2,670
Tobacco excise taxes and dues payable	556,993	600,985	213,018
Income taxes payable	3,510	3,787	29,096
Payments of retirement and severance benefits	(12,358)	(13,334)	(3,991)
Decrease (increase) in deposit for severance benefit trust	2,932	3,164	(368)
Other, net	(9,723)	(10,491)	1,353
Net cash provided by operating activities	<u>1,068,685</u>	<u>1,153,091</u>	<u>663,672</u>

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows, Continued

Six -month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from investing activities:			
Decrease in short-term financial instruments	₩ -	\$ -	₩ 141,000
Decrease (increase) in guarantee deposits	(92)	(99)	2,584
Proceeds from sale of available-for-sale securities	13,229	14,274	5,180
Proceeds from sale of equity method investment securities	-	-	40,148
Proceeds from sale of property, plant and equipment	14,423	15,562	4,543
Decrease (increase) in long-term loans to employees	(4,270)	(4,607)	13,083
Purchases of available-for-sale securities	(219,644)	(236,992)	(4,730)
Purchases of property, plant and equipment	(98,659)	(106,451)	(90,487)
Purchases of intangible assets	(887)	(957)	(414)
Increase in long-term deposit in the Escrow Fund	(14,402)	(15,539)	(12,055)
Increase in other investments	(1,293)	(1,396)	(756)
Other, net	1,866	2,013	(407)
Net cash provided (used) in investing activities	<u>(309,729)</u>	<u>(334,192)</u>	<u>97,689</u>
Cash flows from financing activities:			
Increase (decrease) in guarantee deposits received	(3,860)	(4,165)	412
Proceeds from short-term borrowings	106,901	115,344	89,064
Proceeds from long-term borrowings	1,056	1,139	105
Reissuance of treasury stock	-	-	22,763
Reacquisition of treasury stock	(269,410)	(290,688)	(160,819)
Repayment of short-term borrowings	(106,686)	(115,112)	(76,210)
Payment of dividends	<u>(319,712)</u>	<u>(344,963)</u>	<u>(249,703)</u>
Net cash used in financing activities	<u>(591,711)</u>	<u>(638,445)</u>	<u>(374,388)</u>
Net increase in cash and cash equivalents from change of subsidiaries in consolidated financial statements	(888)	(958)	4,531
Increase in cash & cash equivalents due to merger	<u>415</u>	<u>448</u>	<u>-</u>
	<u>(473)</u>	<u>(510)</u>	<u>4,531</u>
Net increase in cash and cash equivalents	166,772	179,944	391,504
Cash and cash equivalents at beginning of period	<u>201,869</u>	<u>217,813</u>	<u>348,909</u>
Cash and cash equivalents at end of period	₩ <u>368,641</u>	\$ <u>397,757</u>	₩ <u>740,413</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Three-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from operating activities:			
Net income	₩ 198,516	\$ 214,195	₩ 154,803
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	37,790	40,775	33,321
Amortization of present value discounts	(3,304)	(3,565)	(2,938)
Loss (gain) on valuation of inventories, net	(153)	(165)	5,606
Bad debts expense	20,100	21,688	463
Loss on impairment of available-for-sale securities	2,150	2,320	763
Loss (gain) on valuation of equity method investment securities	26	28	(2,071)
Gain on sale of equity method investment securities	-	-	(17,428)
Loss (gain) on foreign currency transactions, net	1,084	1,170	(741)
Other bad debts expense	46	50	712
Provision for retirement and severance benefits	13,420	14,480	9,849
Gain on sale of property, plant and equipment, net	(1,468)	(1,584)	(2,073)
Provision for Tobacco Production Stabilization Fund	4,634	5,000	4,521
Deferred income tax liabilities (assets)	(3,010)	(3,248)	5,590
Minority interest in losses of consolidated subsidiaries	(11,282)	(12,173)	(1,039)
Decrease (increase) in assets:			
Trade accounts receivable	(42,679)	(46,052)	(50,068)
Other receivables	13,095	14,129	2,144
Accrued income	1,206	1,301	1,267
Advance payments	(50,204)	(54,169)	(29,915)
Prepaid expenses	20,296	21,899	17,886
Inventories	106,937	115,383	126,414
Long-term advance payments	(33,918)	(36,597)	(31,444)
Increase (decrease) in liabilities:			
Trade accounts payable	848	915	(3,519)
Other payables	(112,966)	(121,888)	735
Advance receipts	(8,564)	(9,240)	(8,662)
Withholdings	(7,471)	(8,061)	(9,856)
Value added tax payable	8,183	8,829	36,680
Accrued expenses	(1,323)	(1,427)	(3,421)
Tobacco excise taxes and dues payable	198,741	214,438	111,200
Income taxes payable	70,386	75,945	19,264
Payments of retirement and severance benefits	(3,804)	(4,104)	(2,417)
Decrease in deposit for severance benefit trust	317	342	175
Other, net	(10,508)	(11,340)	2,630
Net cash provided by operating activities	<u>407,121</u>	<u>439,276</u>	<u>368,431</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows, Continued

Three-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from investing activities:			
Decrease in short-term financial instruments	₩ 80,000	\$ 86,318	₩ 180,000
Proceeds from sale of available-for-sale securities	13,102	14,137	124
Proceeds from sale of equity method investment securities	-	-	40,148
Proceeds from sale of property, plant and equipment	4,567	4,928	4,012
Decrease in long-term loans to employees	6,795	7,332	8,945
Purchases of available-for-sale securities	(218,462)	(235,716)	(1,230)
Purchases of property, plant and equipment	(63,042)	(68,021)	(50,525)
Purchases of intangible assets	(693)	(748)	(198)
Increase in guarantee deposits	(82)	(88)	(1,091)
Increase in long-term deposit in the Escrow Fund	(6,350)	(6,852)	(8,504)
Decrease (increase) in other investments	6	6	(554)
Other, net	<u>1,833</u>	<u>1,978</u>	<u>(491)</u>
Net cash provided (used) in investing activities	<u>(182,326)</u>	<u>(196,726)</u>	<u>170,636</u>
Cash flows from financing activities:			
Increase (decrease) in guarantee deposits received	(1,937)	(2,091)	998
Proceeds from short-term borrowings	94,089	101,520	36,950
Proceeds from long-term borrowings	1,056	1,139	-
Reissuance of treasury stock	(269,410)	(290,688)	22,763
Repayment of short-term borrowings	(106,686)	(115,112)	(31,834)
Payment of dividends	<u>(319,712)</u>	<u>(344,963)</u>	<u>(249,703)</u>
Net cash used in financing activities	<u>(602,600)</u>	<u>(650,195)</u>	<u>(220,826)</u>
Net increase (decrease) in cash and cash equivalents	(377,805)	(407,645)	318,241
Cash and cash equivalents at beginning of period	<u>746,446</u>	<u>805,402</u>	<u>422,172</u>
Cash and cash equivalents at end of period	₩ <u><u>368,641</u></u>	\$ <u><u>397,757</u></u>	₩ <u><u>740,413</u></u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Changes in Stockholders' Equity

Six-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	Korean Won							U.S. dollars (note 2)
	Common stock	Capital surplus	Capital adjustments	Accumulated other Comprehensive income	Retained earnings	Minority interest	Total	
Balance at January 1, 2006	₩ 954,959	299,979	(349,885)	22,938	2,519,737	23,136	3,470,865	
Net income	-	-	-	-	251,560	-	251,560	
Minority interest in losses of consolidated subsidiaries	-	-	-	-	-	(1,662)	(1,662)	
Reacquisition of treasury stock	-	-	(160,819)	-	-	-	(160,819)	
Reissuance of treasury stock	-	9,881	9,134	-	-	-	19,015	
Retirement of treasury stock	-	-	160,819	-	(160,819)	-	-	
Dividends	-	-	-	-	(249,703)	-	(249,703)	
Decrease in gain on valuation of available-for-sale securities	-	-	-	(8,601)	-	-	(8,601)	
Decrease in gain on valuation of equity method investment securities	-	-	-	(145)	-	-	(145)	
Changes in translation adjustments	-	-	-	(282)	-	-	(282)	
Other	-	-	-	-	162	20	182	
Balance at June 30, 2006	₩ 954,959	309,860	(340,751)	13,910	2,360,937	21,494	3,320,410	
Balance at January 1, 2007	₩ 954,959	335,350	(321,904)	15,791	2,061,349	20,218	3,065,763	\$ 3,307,901
Net income	-	-	-	-	328,029	-	328,029	353,937
Minority interest in losses of consolidated subsidiaries	-	-	-	-	-	(12,205)	(12,205)	(13,169)
Reacquisition of treasury stock	-	-	(269,410)	-	-	-	(269,410)	(290,688)
Compensation by treasury stock	-	4,606	3,331	-	-	-	7,937	8,564
Retirement of treasury stock	-	-	269,410	-	(269,410)	-	-	-
Dividends	-	-	-	-	(319,712)	-	(319,712)	(344,963)
Decrease in gain on valuation of available-for-sale securities	-	-	-	3,721	-	-	3,721	4,015
Decrease in gain on valuation of equity method investment securities	-	-	-	491	-	-	491	530
Changes in translation adjustments	-	-	-	(372)	-	-	(372)	(401)
Other	-	-	-	-	(96)	(72)	(168)	(182)
Balance at June 30, 2007	₩ 954,959	339,956	(318,573)	19,631	1,800,160	7,941	2,804,074	\$ 3,025,544

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2007 and December 31, 2006

(In millions of Korean Won, except where otherwise stated)

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

(a) Description of Business

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

As of June 30, 2007, KT&G has four manufacturing plants, including the Shin Tan Jin plant, and 14 local headquarters and 168 branches for the sale of tobacco throughout the country. Also KT&G has two plants for fabrication of leaf tobacco, including the Nam Won plant, and the Chun Ahn printing plant for the manufacturing of wrapping paper.

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

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

The ownership of the Company's issued common stock at June 30, 2007 is held as follows:

<u>Stockholder</u>	<u>Number of shares</u>	<u>Percentage of ownership</u>
Industrial Bank of Korea	9,510,485	6.63%
Employee Stock Ownership Association	8,274,966	5.77%
Treasury stock	14,070,949	9.81%
Others	<u>111,586,097</u>	<u>77.79%</u>
	<u>143,442,497</u>	<u>100.00%</u>

The Company has, thus far, reacquired and retired 47,549,400 shares of treasury stock. Accordingly, as of June 30, 2007, the Company's common stock differs from the aggregate par value of issued shares by ₩237,747.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(In millions of Korean Won, except where otherwise stated)

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

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

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

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

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

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

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

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

(*3) KT&G USA, Inc.'s affiliation with the Company was terminated in the six-month period ended June 30, 2007 with the completion of the company's liquidation process.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

- (ii) Significant account balances which occurred in the normal course of business with and between subsidiaries as of June 30, 2007 and December 31, 2006 are summarized as follows (these amounts have been eliminated in consolidation):

	<u>Transaction party</u>	<u>Balance sheet item</u>		<u>June 30, 2007</u>	<u>December 31, 2006</u>
KT&G	TAI	Trade accounts payable	₩	1,387	-
KT&G	KT&G USA	Trade accounts receivable		-	9,192
KGC	KT&G	Trade accounts receivable		7	13
KGC	KT&G	Guarantee deposits		2,052	2,323
KGC	KT&G	Prepaid expense		1,946	497
KGC	KGHK	Trade accounts receivable		4,795	7,863
KGC	YJPI	Trade accounts receivable		-	78

- (iii) Significant transactions which occurred in the normal course of business with and between consolidated subsidiaries for the six-month periods ended June 30, 2007 and 2006 are summarized as follows (these amounts have been eliminated in consolidation):

	<u>Transaction party</u>	<u>Income statement item</u>		<u>2007</u>	<u>2006</u>
KT&G	KGC	Sales	₩	800	831
KT&G	YJPI	Sales		39	39
KT&G	KT&G USA	Sales		-	6,214
KT&G	KGC	Other income		6,774	5,253
KT&G	YJPI	Other income		1	35
KGC	KT&G	Sales		930	809
KGC	YJPI	Sales		460	-
KGC	KGHK	Sales		5,246	3,352
KGC	TAI	Sales		10	2
YJPI	KT&G	Sales		45	115
YJPI	KGC	Sale of property, plant & equipment		9,130	-
TAI	KT&G	Sales		6,496	3,916

- (iv) As of June 30, 2007, KGC has provided guarantees for KGHK (within the limit of USD20,000) on its short-term borrowings amounting to USD7,000.

(c) Cash Equivalents

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

(d) Financial Instruments

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

(e) Allowance for Doubtful Accounts

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

(f) Inventories

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-process; using the moving-average method for raw materials and supplies; and using the specific identification method for goods-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. Amounts of any write-down of inventories to net realizable value due to obsolescence or excess inventory and other losses of inventories occurring in the normal course of business are recognized as cost of goods sold and such valuation losses are deducted from the inventories as allowance for valuation losses. The Company has recognized loss and reversal of loss on valuation of inventories amounting to ₩26,924 and ₩17,294, respectively, for the six-month period ended June 30, 2007. Also, the estimated amounts of inventories in current assets which are not expected to be realized within a year are ₩282,043 and ₩411,239, respectively, as of June 30, 2007 and December 31, 2006.

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

The Company did not make a count of the physical inventory as of June 30, 2007 and 2006.

(g) Investment in Securities

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

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

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

(g) Investment in Securities, Continued

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

(h) Investment Securities under the Equity Method

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

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

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

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

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

(i) Property, Plant and Equipment

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

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

(i) Property, Plant and Equipment, Continued

Depreciation is computed using the straight-line or declining-balance method based on estimated useful lives of the respective assets as follows:

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

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

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

(j) Leases

The Company accounts for and classified its lease transactions as either an operating or capital lease, depending on the terms of the lease under Statement of Korea Accounting Standards. When a lease is substantially noncancellable and meets one or more of the criteria listed below, the present value of future minimum lease payments is reflected as an obligation under capital lease.

- Ownership of the leased property shall be transferred to the lessee at the end of the lease term without additional payment or for a contract price.
- The lessee has a bargain purchase option.
- The lease term is equal to 75% or more of the estimated economic useful life of the leased property.
- The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair value of the leased property.

Otherwise, the lease is classified as an operating lease with lease payments expensed as incurred.

(k) Goodwill

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

(l) Intangible Assets

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

(l) Intangible Assets , continued

(i) Research and Development Costs

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

(ii) Other Intangible Assets

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

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

(m) Valuation of Receivables and Payables at Present Value

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

(n) Retirement and Severance Benefits

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

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

(o) 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 ₩926.80 to USD1, the rate of exchange on June 30, 2007 that is permitted by the Financial Accounting Standards. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Korean Won at the foreign exchange rate on the date of the transaction.

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

(p) Revenue Recognition

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

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

(q) Income Taxes

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

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

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

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

(r) 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.

(s) 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.

(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.

(v) Foreign Currency Translation of Foreign Subsidiaries

Assets and liabilities of foreign subsidiaries and operations are translated into Korean Won at the rate of ₩926.80 to USD1, the basic exchange rate on June 30, 2007. Income and expense items are translated at the average exchange rates of the fiscal year. Gains and losses resulting from such translations of financial statements are recognized as a foreign-based operations translation gain (loss) in stockholders' equity.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(2) Basis of Translating Consolidated Financial Statements

The consolidated financial statements are expressed in Korean Won and, solely for the convenience of the reader, have been translated into United States dollars at the rate of ₩926.80 to USD1, the basic exchange rate on June 30, 2007. These translations should not be construed as a representation that any or all of the amounts shown could be converted into United States dollars at this or any other rate.

(3) Restricted Deposits

Financial instruments restricted in use as security for maintaining checking accounts as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Long-term financial instruments	₩ <u>46</u>	<u>44</u>

(4) Transfers of Trade Accounts Receivable

Outstanding export trade accounts and notes receivable transferred to and discounted with third parties as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Export trade accounts receivable	₩ 296	3,195
Notes receivable	<u>13,610</u>	<u>12,515</u>
	₩ <u>13,906</u>	<u>15,710</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(5) Inventories

Inventories as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Merchandise, net of allowance for valuation losses	₩ 1,518	1,440
Finished goods, net of allowance for valuation losses	127,092	136,231
Semi-finished goods	22,108	13,329
Work-in-process, net of allowance for valuation losses	120,528	218,190
Raw materials, net of allowance for valuation losses	754,891	878,729
Subsidiary material, net of allowance for valuation losses	700	567
Supplies	20,412	19,751
By-products	3,703	4,267
Completed buildings (note 27)	21,198	2,745
Sites for building lotting-out construction (note 27)	14,032	11,571
Goods-in-transit	14,890	12,949
	<u>₩ 1,101,072</u>	<u>1,299,769</u>

(6) Other Current Assets

Other current assets as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Accrued income	₩ 1,593	242
Other receivables (note 21)	27,005	25,517
Prepaid expenses	15,338	7,026
Prepaid income taxes	4	396
Trade guarantee deposits	129	122
Short-term loans to employees	17,967	19,255
Advance payments (notes 11 and 25)	111,758	30,292
Financial derivative assets	108	-
Available-for-sale securities (note 7)	85	555
	<u>₩ 173,987</u>	<u>83,405</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(7) Available-for-sale Securities

Available-for-sale securities as of June 30, 2007 and December 31, 2006 are summarized as follows:

(a) Equity securities

Company	Number of shares	Percentage of ownership	Acquisition cost	Fair value (*5)	Book value	
					2007	2006
Marketable securities:						
Yonhap Television News	8,380,000	19.95%	₩ 5,102	41,565	41,565	28,366
Crystal Genomics Co., Ltd.	111,000	1.96%	2,875	1,821	1,821	1,582
Shinhan Financial Group Co., Ltd.	230,770	3.54%	2,250	2,769	2,769	-
Oscotech, Inc.	3,500,000	0.92%	205,532	196,700	196,700	2,250
			<u>215,759</u>	<u>242,855</u>	<u>242,855</u>	<u>32,198</u>
Non-marketable securities:						
Celltrion, Inc.	3,791,368	13.93%	21,245	21,245	21,245	21,245
Nexgen Biotechnologies, Inc. (*2)	1,000,000	11.84%	2,150	-	-	2,150
KT&G Turkey (*1)	9,900	99.00%	16,316	14,981	14,981	869
Cosmo Tobacco Co., Ltd. (*1)(*2)	480,000	40.00%	2,540	-	-	-
Innodis Co., Ltd.	110,000	19.64%	55	55	55	55
REXAHN Pharmaceuticals, Inc.	2,500,000	4.97%	2,359	2,359	2,359	2,359
Lifenza, Inc. (*2)	29,047	13.01%	1,600	-	-	-
Korea Islet Transplantation Institute, Inc. (*1)	110,500	48.25%	2,000	2,000	2,000	2,000
KT&G Mongolia LLC (*1)	40,000	100.00%	201	201	201	201
Korea Tabacos do Brasil Ltda. (*1) (*3)	-	99.90%	394	394	394	394
Genematrix, Inc.	300,000	10.49%	1,500	1,500	1,500	1,500
Litepharmtech, Inc. (*1)	50,000	29.41%	1,000	1,000	1,000	1,000
Hurum, Inc.	7,800	9.75%	39	39	39	39
MD Bioalpha Co., Ltd.	65,852	5.00%	667	667	667	667
OCT USA, Inc.	48,780	19.97%	927	927	927	927
Nongsusan TV Co., Ltd.	200,000	3.09%	-	-	-	1,100
The Korea Economic Daily	287	-	5	5	5	5
Ddrug Co., Ltd. (*4)	-	-	4	4	4	4
Husis Co., Ltd.	-	-	210	13	13	13
Yungjin Co., Ltd. (*1)	16,760	41.90%	168	-	-	-
Yungjin Health Food Co., Ltd. (*1)	17,900	29.80%	90	-	-	-
			<u>53,470</u>	<u>45,390</u>	<u>45,390</u>	<u>34,528</u>
			<u>₩ 269,229</u>	<u>288,245</u>	<u>288,245</u>	<u>66,726</u>

(*1) 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.

(*2) The Company wrote off its equity interest in Nexgen Biotechnologies, Inc. as the decline in the value was judged to be other than temporary, and recorded a ₩2,150 loss which is charged to current results of operations for the six-month period ended June 30, 2007. In the prior period, the Company also wrote off investments in Lifenza, Inc. and Cosmo Tobacco Co., Ltd. for the same reason.

(*3) Stock certificates are not issued.

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

(*5) Non-marketable securities other than those of Nexgen Biotechnologies, Inc., Lifenza, Inc. and Cosmo Tobacco Co., Ltd. are recorded at cost since their fair value is not available or readily determinable.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

Description	Interest rate per annum	Acquisition cost	Fair value	Book value	
				2007	2006
Current assets:					
Government and municipal bonds	3.0 ~ 7.0%	₩ 85	85	85	555
Non-current assets:					
Government and municipal bonds	3.0 ~ 7.0%	2,393	2,403	2,403	2,430
Oscotech, Inc.	10.0%	1,000	1,000	1,000	1,000
Litepharmtech, Inc.	8.0%	1,000	1,000	1,000	1,000
		4,393	4,403	4,403	4,430
		₩ 4,478	4,488	4,488	4,985

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

- (a) Affiliates' equity securities accounted for using the equity method as of June 30, 2007 and December 31, 2006 are summarized as follows:

Affiliate	Number of shares	Percentage of ownership	2007	2006
KGC Sales Co., Ltd.	300,000	100.00%	₩ 1,361	1,111
Yungjin Distribution Co., Ltd.	-	-	-	-
			₩ 1,361	1,111

On January 17, 2007, Yungjin Pharm. Ind. Co., Ltd., a subsidiary of the Company, merged Yungjin Distribution Co., Ltd. into itself.

- (b) Changes in unrealized gains from inter-company transactions for the six-month ended June 30, 2007 are summarized as follows:

Affiliate	Beginning balance	Increase	Realized amount	Ending balance
KGC Sales Co., Ltd.	₩ 149	428	(149)	428

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

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

- (c) Details of changes in affiliates' equity securities accounted for using the equity method after acquisition through June 30, 2007 are as follows:

Affiliate	Acquisition cost	Adjustment to retained earnings		June 30, 2007
		Prior to 2007	2007	
KGC Sales Co., Ltd.	₩ 1,500	(389)	250	1,361

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

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

- (e) Summarized financial information of affiliate as of and for the six-month period ended June 30, 2007 is as follows:

Affiliate	Total assets	Total liabilities	Sales	Net income
KGC Sales Co., Ltd.	₩ 5,118	3,329	7,841	529

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(9) Transactions and Balances with Related Companies

(a) The Company's unconsolidated subsidiaries as of June 30, 2007 are as follows:

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

(b) Significant transactions and account balances which occurred in the normal course of business with related companies as of June 30, 2007 and December 31, 2006 and for six-month periods ended June 30, 2007 and 2006 are summarized as follows:

(i) Sales

	2007	2006
KGC Sales Co., Ltd.	₩ 6,849	5,269
KT&G Turkey	79	-
KT&G Mongolia LLC	680	-
KT&G USA, Inc.	1,694	-
Yungjin Distribution Co., Ltd.	-	4,513
	₩ 9,302	9,782

(ii) Other expenses

	2007	2006
KT&G Turkey	₩ 74	-
Korea Tabacos do Brasil Ltda.	48	73
	₩ 122	73

(iii) Due from affiliates

	2007			2006		
	Trade accounts receivable	Other	Total	Trade accounts receivable	Other	Total
KT&G Turkey	₩ -	-	-	-	1,249	1,249
KT&G Mongolia LLC	451	238	689	232	238	470
Yungjin Distribution Co., Ltd.	-	-	-	20,549	-	20,549
Yungjin Co., Ltd.	-	-	-	2,301	-	2,301
KGC Sales Co., Ltd.	2,533	-	2,533	2,047	-	2,047
Yungjin Health Food Co., Ltd.	4,310	-	4,310	4,310	-	4,310
	₩ 7,294	238	7,532	29,439	1,487	30,926

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(9) Transactions and Balances with Related Companies, Continued

- (c) Due from the stockholders, directors and employees as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Loans for employee housing and tuition	₩ 31,793	33,401
Loans to Employee Stock Ownership Association	14,591	25,005
Other	<u>38,592</u>	<u>22,319</u>
	<u>₩ 84,976</u>	<u>80,725</u>

- (d) Details of compensation to uppermost executives for the six-month periods ended June 30, 2007 and 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Short-term payroll	₩ 2,741	1,550
Post-retirement pay	<u>3,607</u>	<u>1,100</u>
	<u>₩ 6,348</u>	<u>2,650</u>

- (e) The guarantees that the Company has provided for a related company as of June 30, 2007 is as follows:

<u>Related company</u>	<u>Type of Guarantee</u>	<u>Financial institution</u>	<u>Guaranteed amount</u>
KT&G Turkey	Payment guarantee on foreign currency letter of credit opened in connection with the acquisition of tobacco manufacturing machinery	Korea Exchange Bank (Deutschland) AG	10,000,000 Euros in addition to incidental expenses and interest expense

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(10) Long-term Loans Receivable

Long-term loans receivable as of June 30, 2007 and December 31, 2006 are as follows:

	Interest rate per annum	Maturity date	2007	2006
Loan to National Leaf Tobacco Growers Cooperative Federation in support of leaf tobacco cultivation (*1)	0.7%	2007.11.20	₩ 110,000	110,000
Loan to Korea Ginseng Cooperative Federation in support of ginseng cultivation	1.5%	2007.12.21	1,400	1,400
Other	-	-	<u>2,283</u>	<u>2,677</u>
			113,683	114,077
Less: Present value discount account (*2)			(4,976)	(11,416)
Allowance for doubtful accounts			<u>(1,064)</u>	<u>(1,000)</u>
Total net realizable present value			107,643	101,661
Less: Current portion			<u>(105,605)</u>	<u>(99,647)</u>
			<u>₩ 2,038</u>	<u>2,014</u>

(*1) The repayment of the loan is guaranteed by the National Agricultural Cooperative Federation.

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

(11) Advance Payments

The Company maintains contracts 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 June 30, 2007 and December 31, 2006, advance payments paid to the farmers in accordance with the contracts are as follows:

Classification	Account	2007	2006
Two-year old ginseng	Long-term advance payments	₩ 33,984	-
Three-year old ginseng	Long-term advance payments	31,767	31,776
Four-year old ginseng	Long-term advance payments	26,619	26,627
Five-year old ginseng	Long-term advance payments	<u>21,887</u>	<u>22,012</u>
		114,257	80,415
Six-year old ginseng	Shot-term advance payments	<u>59,812</u>	<u>27,433</u>
Total		<u>₩ 174,069</u>	<u>107,848</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(12) Property, Plant and Equipment

(a) Changes in property, plant and equipment for the six-month period ended June 30, 2007 are as follows:

	January 1, 2007	Change of subsidiaries	Increase due to merger	Acquisition	Disposal	Depreciation	Other	June 30, 2007
Land	₩ 381,944	-	-	537	(3,096)	-	1,762	381,147
Buildings	499,947	-	-	3,466	(3,553)	(12,466)	23,695	511,090
Structures	28,557	-	2	472	(208)	(1,210)	745	28,381
Machinery and equipment	369,761	-	-	3,724	(1,981)	(36,191)	12,312	347,625
Vehicles and other transportation equipment	5,872	-	-	407	(191)	(1,835)	46	4,299
Tools	11,523	-	8	1,468	-	(2,539)	-	10,460
Furniture and fixtures	79,928	(52)	-	16,793	(44)	(18,879)	171	77,917
Other tangible fixed assets	605	-	-	10	-	-	-	615
Construction-in-progress	<u>84,607</u>	<u>-</u>	<u>-</u>	<u>71,782</u>	<u>-</u>	<u>-</u>	<u>(38,580)</u>	<u>117,809</u>
	₩ <u>1,462,744</u>	<u>(52)</u>	<u>33</u>	<u>98,659</u>	<u>(9,072)</u>	<u>(73,120)</u>	<u>151</u>	<u>1,479,343</u>

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

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

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

(13) Officially Declared Value of Land

The officially declared value of land at June 30, 2007, as announced by the Minister of Construction and Transportation, is ₩1,366,867. 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 ₩1,284,813 as of June 30, 2007 with DongBu Insurance Co., Ltd. and others. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(15) Leases

The Company leases vehicles and computers. Future minimum lease payments under non-cancelable capital and operating leases as of June 30, 2007 are as follows:

Year	Amount
2007	₩ 157
2008	313
2009 and thereafter	331
Total minimum lease payments	₩ <u>801</u>

(16) Other Assets

Other assets as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Long-term financial instruments (note 3)	₩ 46	44
Long-term accrued interest	70	27
Long-term trade accounts receivable, net of allowance for doubtful accounts of ₩26,475 in 2007 and ₩12,003 in 2006	2,524	-
Long-term advance payments, net of allowance for doubtful accounts of ₩1,142 in 2007 and ₩804 in 2006 (notes 11 and 25)	115,914	80,603
Long-term other receivables	<u>1,689</u>	<u>-</u>
	₩ <u>120,243</u>	<u>80,674</u>

(17) Other Current Liabilities

Other current liabilities as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Withholdings	₩ 14,842	15,718
Unearned income	238	418
Leasehold deposits received	92	212
Provision for obligation under mileage program	<u>3,478</u>	<u>2,035</u>
	₩ <u>18,650</u>	<u>18,383</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(18) Short-term Borrowings

Short-term borrowings as of June 30, 2007 and December 31, 2006 are summarized as follows:

Type of borrowings	Lender	Interest rate per annum		2007	2006
Credit loans	Hana Bank	6.98%	₩	13,000	13,000
Credit loans	Hana Bank	7.58		1,000	3,500
Loans for facilities	Hana Bank	6.96%		8,000	8,000
Loans for purchasing capital	Hana Bank	6.91%		975	815
General loan	Hana Bank	5.22%		1,200	1,200
Comprehensive export financing loan	Export-Import Bank of Korea	5.04%		-	2,000
Commercial paper	Hana Securities Co., Ltd.	5.90%		5,000	10,000
Commercial paper	Korea Exchange Bank	5.18~5.93%		15,000	15,000
Commercial paper	Woori Bank	6.20%		5,000	10,000
Commercial paper	Kumho Investment Bank	5.90%		-	5,000
Commercial paper	SK Securities Co., Ltd.	6.37%		5,338	10,000
Commercial paper	Woori Securities Co., Ltd.	5.90~6.00%		20,000	-
Loans for foreign currency working capital	Korea Exchange Bank	1Y LIBOR+0.80%		3,400	2,271
Loans for foreign currency working capital	Standard Chartered First Bank Korea Ltd.	1Y LIBOR+0.80%		3,033	-
			₩	<u>80,946</u>	<u>80,786</u>

(19) Long-term Borrowings

(a) Long-term borrowings as of June 30, 2007 and December 31, 2006 are summarized as follows:

Type of borrowings	Lender	Maturity date	Interest rate per annum		2007	2006
Environmental Management Corporation Loan	Hana Bank	2017.03.31	4.79%	₩	1,056	-
Energy Rationalization Fund	Hana Bank	2013.03.15	3.75%		1,402	1,402
				₩	<u>2,458</u>	<u>1,402</u>

(b) Repayment schedule for the Company's long-term borrowings as of June 30, 2007 is as follows:

Period ending June 30,	Amount
2008	₩ -
2009	280
2010	280
2011	280
thereafter	<u>1,618</u>
	₩ <u>2,458</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(20) Retirement and Severance Benefits

Changes in the retirement and severance benefits for the six-month period ended June 30, 2007 and the year ended December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Estimated retirement and severance benefits accrual at beginning of period	₩ 208,923	160,891
Increase due to change of consolidated subsidiaries	-	2,126
Provision for retirement and severance benefits	16,487	57,437
Payments (*)	<u>(18,694)</u>	<u>(11,531)</u>
Estimated retirement and severance benefits accrual at end of period	206,716	208,923
Deposit for severance benefits trust	(106,084)	(108,939)
Contribution to the National Pension Fund	<u>(477)</u>	<u>(478)</u>
Net balance at end of period	₩ <u>100,155</u>	<u>99,506</u>

(*) Remuneration paid with treasury shares amounting to ₩6,336 for the six-month period ended June 30, 2007 is included.

The Company maintains employees' severance benefit trust arrangements with Samsung Life Insurance Co., Ltd. and other financial institutions. Under these arrangements, the Company has made an aggregate deposit in the amount equal to 51.3% and 52.1% of the reserve balances of retirement and severance benefits as of June 30, 2007 and December 31, 2006, respectively. This deposit is to be used to make the required payments to the retirees and accounted for as a reduction of the reserve balance.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(21) Assets and Liabilities Denominated in Foreign Currencies

Details of assets and liabilities denominated in foreign currencies as of June 30, 2007 and December 31, 2006 are as follows: (In thousands of USD, JPY, NTD, HKD, EUR and GBP)

		Foreign currency		Korean Won equivalent	
		2007	2006	2007	2006
Assets:					
Cash and cash equivalents	USD	4,672	1,708	₩ 4,330	1,587
	JPY	92,034	67,453	692	527
	NTD	2,279	4,520	64	129
	USD	136,514	118,793	126,520	110,430
Trade accounts receivable	JPY	165,956	119,388	1,249	933
	HKD	700	1,495	83	179
	NTD	127	89	4	3
	USD	259	134	240	125
Other receivables	USD	259	134	240	125
Long-term deposits in the Escrow Fund	USD	<u>64,463</u>	<u>49,065</u>	<u>59,744</u>	<u>45,611</u>
Total	USD	205,908	169,700		
	JPY	257,990	186,841		
	HKD	700	1,495		
	NTD	<u>2,406</u>	<u>4,609</u>	₩ <u>192,926</u>	<u>159,524</u>
Liabilities:					
Trade accounts payable	USD	5,263	7,148	₩ 4,878	6,645
	EUR	2,864	-	3,568	-
	JPY	15,480	11,728	116	92
	GBP	-	96	-	175
Short-term borrowings	USD	<u>6,940</u>	<u>2,450</u>	<u>6,432</u>	<u>2,271</u>
Total	USD	12,203	9,598		
	EUR	2,864	-		
	JPY	15,480	11,728		
	GBP	<u>-</u>	<u>96</u>	₩ <u>14,994</u>	<u>9,183</u>

(22) Capital Adjustments

Capital adjustments as of June 30, 2007 and December 31, 2006 are summarized as follows:

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

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(23) Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of June 30, 2007 and December 31, 2006 is summarized as follows:

	<u>2007</u>	<u>2006</u>
Unrealized gain on valuation of available-for-sale securities	₩ 19,651	15,929
Unrealized gain on valuation of equity method investment securities	1,499	1,009
Unrealized loss on valuation of equity method investment securities	<u>(1,519)</u>	<u>(1,147)</u>
	₩ <u>19,631</u>	<u>15,791</u>

(24) Retained Earnings

(a) Details of retained earnings as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</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	45,000	45,000
Reserve for loss on reissuance of treasury stock	26,646	26,646
Other appropriations	350,000	880,000
Unappropriated (undisposed) retained earnings (deficit) at end of period	<u>63,845</u>	<u>(204,966)</u>
	₩ <u>1,800,160</u>	<u>2,061,349</u>

(b) Legal Reserve

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

(c) Reserve for Business Expansion

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

(d) Reserve for Business Rationalization

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

Effective December 11, 2002, the Company has no longer been 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.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(24) Retained Earnings, Continued

(e) Other Reserves

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

(25) Commitments and Contingencies

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

The Company recorded ₩59,744 and ₩45,611 as of June 30, 2007 and December 31, 2006 as a long-term deposit the amounts paid into the Escrow Fund of State governments in the United States against potential litigation and damages relative to the tobacco exportation into the United States. The Escrow Fund would be refunded, if the Company did not indemnify the state governments for damages for 25 years on the ground that the Company did not sell cigarettes illegally.

As of June 30, 2007, tobacco lawsuits claiming damages of ₩1,282 were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligation to notify smokers of the potential health hazards of smoking. Additionally, the Company is involved in 13 lawsuits and claims for alleged damages aggregating ₩7,863 as of June 30, 2007. The amount of the liability the Company may ultimately have with respect to the litigation cannot be reasonably estimated as of June 30, 2007.

As of June 30, 2007, the Company has provided to the National Agricultural Cooperative Federation ("NACF") and another bank guarantees in the aggregate of ₩12,371 for the customers who made a financing agreement with these lenders.

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

As of June 30, 2007, the Company's trade accounts receivable arisen from export of cigarettes was insured against dishonor up to USD31,000 by an export guaranty insurance with the Korea Export Insurance Corporation.

As of June 30, 2007, the Company has been provided with a foreign currency payment guarantee for local dealers in Russia and another country up to USD70,000 by Korea Exchange Bank and other financial institutions.

The Company made a currency forward contract with the Korea Exchange Bank up to USD20,000 and the outstanding amount of the contract is USD6,000 as of June 30, 2007.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(25) Commitments and Contingencies, Continued

The Company provided KT&G Turkey with a payment guarantee on the foreign currency Letter of Credit (LC), with a limit of EUR 10,000,000, plus incidental expenses and interest expense, which LC was opened at Korea Exchange Bank AG in connection with the acquisition of tobacco manufacturing machinery.

The Company entered into an overdraft agreement with a limit of ₩200,000 with the National Agricultural Cooperative Federation ("NACF") as of June 30, 2007

Korea Ginseng Corporation maintains a purchase contract with the farmers who grow six-year old green ginseng for easier procurement. As of June 30, 2007 and December 31, 2006, short- and long-term advances paid to the farmers in accordance with the contracts amounted to ₩174,069 and ₩107,848, respectively.

As of June 30, 2007, the Company has entered into note discounting contracts with Hana Bank and other financial institutions with aggregate line of credit of ₩22,000, and amounts of outstanding trade notes receivable transferred and notes discounted and endorsed total ₩13,906.

As of June 30, 2007, the Company has provided 15 blank notes and 5 blank checks to Hana Bank and other financial institutions as collateral for its long-term borrowings and trade agreements.

(26) Reserve for Tobacco Production Stabilization Fund

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

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

Changes in the Reserve for Tobacco Production Stabilization Fund for the six-month period ended June 30, 2007 and the year ended December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Beginning balance	₩ 74,484	55,753
Provision for Tobacco Production Stabilization Fund	<u>8,935</u>	<u>18,731</u>
Ending balance	<u>₩ 83,419</u>	<u>74,484</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(27) Building Lotting-out Construction Contracts

(a) Building lotting-out construction contracts as of June 30, 2007 are summarized as follows:

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

(b) Details of installment sales as of June 30, 2007 are summarized as follows:

	<u>Expected contract amount</u>	<u>Confirmed contract amount</u>	<u>Recognized revenue</u>		<u>Unrecognized revenue</u>
			<u>Prior to 2007</u>	<u>2007</u>	
Apartment buildings in Jeonju	₩ <u>284,995</u>	<u>44,056</u>	<u>460</u>	<u>5,984</u>	₩ <u>278,551</u>

(c) Cost of installment sales of store units for the three-month periods ended June 30, 2007 and 2006 are as follows:

	<u>2007</u>		<u>2006</u>	
	<u>Three months</u>	<u>Six months</u>	<u>Three months</u>	<u>Six months</u>
Outsourcing cost	₩ 22,362	24,702	4,114	9,117
Land and completed buildings:				
Beginning of the period	16,593	14,316	3,225	9,153
End of the period	<u>(35,230)</u>	<u>(35,230)</u>	<u>(1,120)</u>	<u>(1,120)</u>
Cost of sales of buildings	₩ <u>3,725</u>	<u>3,788</u>	<u>6,219</u>	<u>17,150</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(28) Income Taxes

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

<u>Taxable income</u>	<u>Tax rate</u>
Up to ₩ 100	14.3%
Over ₩ 100	27.5%

The components of income tax expense for the six-month periods ended June 30, 2007 and 2006 are summarized as follows:

	<u>2007</u>		<u>2006</u>	
	<u>Three months</u>	<u>Six months</u>	<u>Three months</u>	<u>Six months</u>
Current income tax expense	₩ 84,406	142,070	69,551	110,438
Deferred income tax expense (benefit)	(2,356)	7,889	8,512	6,806
Income tax expense benefit charged (credited) directly to stockholders' equity	<u>(204)</u>	<u>(3,119)</u>	<u>(-2,923)</u>	<u>(-486)</u>
	<u>₩ 81,846</u>	<u>146,840</u>	<u>75,140</u>	<u>116,758</u>

- (b) The provision for income taxes calculated using the normal tax rates differs from the actual provision for the three-month periods ended June 30, 2007 and 2006 for the following reasons:

	<u>2007</u>	<u>2006</u>
Provision for income taxes at normal tax rate	₩ 148,800	114,081
Tax effects of permanent differences, net	(3,690)	1,880
Tax credit	(2,654)	(479)
Changes in valuation allowance for deferred income tax assets and other	5,344	820
Others	<u>(960)</u>	<u>456</u>
Actual provision for income taxes	<u>₩ 146,840</u>	<u>116,758</u>

The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 31.7% and 31.8% for the six-month periods ended June 30, 2007 and 2006, respectively.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(28) Income Taxes, Continued

- (c) The tax effects of temporary differences that result in significant portions of the deferred income tax assets and liabilities as of June 30, 2007 and December 31, 2006 are presented below:

	<u>2007</u>	<u>2006</u>
Deferred income tax assets:		
Provision for severance and retirement benefits	₩ 33,992	31,780
Loss on valuation of inventories	5,699	5,384
Depreciation	4,638	5,182
Bad debts	1,051	1,426
Impairment losses on property, plant and equipment	279	754
Present value discounts	1,368	3,140
Provision for Tobacco Production Stabilization Fund	22,940	20,483
Other	<u>5,321</u>	<u>5,169</u>
Total deferred tax assets	<u>75,288</u>	<u>73,318</u>
Deferred income tax liabilities:		
Deposit for severance and retirement benefits trust	(28,212)	(28,750)
Reserve for research and human resource development	(20,057)	(23,201)
Equity method investment securities	(99,991)	(86,984)
Reserve for losses on reissuance of treasury stock	(7,328)	(7,328)
Available-for-sale securities	(7,452)	(6,042)
Treasury stock	(15,531)	(15,636)
Other	<u>-</u>	<u>(679)</u>
Total deferred tax liabilities	<u>(178,571)</u>	<u>(168,620)</u>
Net deferred tax liability	(103,283)	(95,302)
Less: Current portion	<u>(8,090)</u>	<u>(8,226)</u>
Deferred tax liabilities	₩ <u><u>(111,373)</u></u>	<u><u>(103,528)</u></u>

- (d) Effective January 1, 2005, the Company adopted SKAS No. 16,
- Income Taxes*
- . In accordance with SKAS No. 16, deferred taxes are recognized on the temporary differences related to unrealized gains and losses that were reported as a separate component of stockholders' equity and the tax effect of the changes in these accounts is charged or credited directly to the separate component of the stockholders' equity. Income tax expenses charged or credited directly to the separate component of stockholders' equity for the three-month periods ended June 30, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Gain on reissuance of treasury stock	₩ (1,747)	(3,748)
Unrealized gain on valuation of available-for-sale securities	(1,409)	3,262
Unrealized gain on valuation of equity method investments	<u>37</u>	<u>-</u>
	₩ <u><u>(3,119)</u></u>	<u><u>(486)</u></u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(28) Income Taxes, Continued

- (e) Under SKAS No. 16, the deferred tax amounts should be presented as a net current asset or liability and a net non-current asset or liability. In addition, the Company is required to disclose aggregate deferred tax assets (liabilities). As of June 30, 2007, details of aggregate deferred tax assets (liabilities) are as follows:

Description	Temporary differences at June 30, 2007	Deferred tax assets (liabilities)	
		Current	Non-current
Deferred tax assets:			
Provision for severance and retirement benefits	₩ 140,752	-	33,992
Loss on valuation of inventories	28,945	5,699	
Depreciation	18,589	-	4,638
Bad debts	46,815	1,051	
Impairment losses on property, plant and equipment	1,523	-	279
Present value discounts	4,977	-	1,368
Provision for Tobacco Production Stabilization Fund	83,419	-	22,940
Other	33,796	1,340	3,981
	<u>358,816</u>	<u>8,090</u>	<u>67,198</u>
Deferred tax liabilities:			
Deposit for severance and retirement benefits trust	(106,837)	-	(28,212)
Reserve for research and human resource development	(72,933)	-	(20,057)
Equity method investment securities	(389,206)	-	(99,991)
Reserve for losses on reissuance of treasury stock	(26,646)	-	(7,328)
Available-for-sale securities	(27,107)	-	(7,452)
Treasury stock	(56,475)	-	(15,531)
	<u>(679,204)</u>	<u>-</u>	<u>(178,571)</u>
	₩ <u>(320,388)</u>	<u>8,090</u>	<u>(111,373)</u>

(29) Earnings Per Share

Earnings per share for the three-month and six-month periods ended June 30, 2007 and 2006 are as follows:

	2007		2006	
	Three months	Six months	Three months	Six months
Net income per accompanying statements of income	₩ 198,516	328,029	154,803	251,560
Weighted-average number of common shares outstanding	<u>132,264,686</u>	<u>132,741,625</u>	<u>144,088,240</u>	<u>144,658,772</u>
Earnings per share in Korean Won	₩ <u>1,501</u>	<u>2,471</u>	<u>1,074</u>	<u>1,739</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(30) Non-cash Investing and Financing Activities

Significant non-cash investing and financing activities for the six-month periods ended June 30, 2007 and 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Retirement of treasury stock	₩ 269,410	160,819
Compensation by treasury stock	9,335	-

(31) Added Value

The components of manufacturing costs and selling and administrative expenses which are necessary in calculating added value for the three-month and six-month periods ended June 30, 2007 and 2006 are as follows:

	<u>2007</u>		<u>2006</u>	
	<u>Three months</u>	<u>Six months</u>	<u>Three months</u>	<u>Six months</u>
Wages and salaries	₩ 91,614	185,209	81,527	166,706
Provision for severance benefits	13,419	16,487	9,849	14,755
Employee welfare	9,360	20,407	9,221	19,658
Rent	3,502	7,920	3,179	7,212
Depreciation	36,513	73,120	32,198	63,716
Taxes and dues	5,790	10,195	5,423	10,588

(32) Employee Welfare and Contributions to Society

For employee welfare, the Company maintains a refectory, an infirmary, athletic facilities, a scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spent for the six-month periods ended June 30, 2007 and 2006 are estimated at ₩20,407 and ₩19,658, respectively.

The Company donated ₩6,946 and ₩41,597 to the KT&G Social Welfare Foundation and others for the three-month periods ended June 30, 2007 and 2006, respectively.

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(33) Selling, General and Administrative Expenses

The details of selling, general and administrative expenses for the three-month and six-month periods ended June 30, 2007 and 2006 are as follows:

	2007		2006	
	Three months	Six months	Three months	Six months
Salaries	₩ 52,929	106,439	46,486	96,059
Provision for severance benefits	10,251	12,236	5,591	9,468
Welfare	6,399	13,406	5,956	12,524
Travel	2,277	4,030	1,792	3,217
Communications	1,176	2,374	1,066	2,085
Utilities	1,080	2,945	1,213	3,071
Taxes and dues	5,071	8,631	4,688	9,168
Supplies	702	1,445	679	1,332
Uniform	37	40	108	110
Rent	2,106	3,900	1,525	3,249
Depreciation	14,222	28,076	12,278	23,710
Amortization	1,121	2,229	1,118	2,227
Repairs and maintenance	1,817	2,489	1,778	2,469
Vehicles	1,883	3,617	1,910	3,587
Insurance	290	659	485	791
Commissions	20,415	40,531	19,316	33,989
Transportation and warehousing	7,733	15,607	6,222	11,802
Entertainment	445	874	448	1,026
Conferences	1,515	3,131	1,684	3,657
Advertising	37,277	75,413	46,165	82,922
Training	2,480	4,699	1,962	3,707
Prizes and rewards	606	1,069	365	695
Cooperation	192	387	138	269
Normal research and development	5,343	10,267	5,331	9,975
Sample	2	3	6	14
Bad debts	20,100	21,985	463	1,138
Miscellaneous	340	863	280	656
	₩ <u>197,809</u>	<u>367,345</u>	<u>169,053</u>	<u>322,917</u>

KT&G CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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

(34) Segment Information

- (a) The Company has three reportable operating segments - manufacturing and selling tobacco (the tobacco segment), manufacturing and selling ginseng products (the ginseng segment), and other.
- (b) Information on each operating segment as of and for the six-month period ended June 30, 2007 is as follows:

		<u>Tobacco segment</u>	<u>Ginseng segment</u>	<u>Other</u>	<u>Consolidation adjustment</u>	<u>Total</u>
Sales	₩	1,144,015	249,331	82,136	(14,024)	1,461,458
Operating income (loss)		396,334	77,980	(24,645)	5,069	454,738
Total assets		4,038,234	571,605	121,174	(530,436)	4,200,577

- (c) Information on each operating segment as of and for the six-month period ended June 30, 2006 is as follows:

		<u>Tobacco segment</u>	<u>Ginseng segment</u>	<u>Other</u>	<u>Consolidation adjustment</u>	<u>Total</u>
Sales	₩	1,041,246	206,326	82,983	(15,277)	1,315,278
Operating income (loss)		316,013	67,022	(1,718)	4,043	385,360
Total assets		4,097,742	466,778	141,792	(451,068)	4,255,244

(35) Merger

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

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

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