

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Financial Statements

(Unaudited)

September 30, 2008 and 2007

(With Independent Auditors' Review Report)

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Financial Statements

(Unaudited)

September 30, 2008 and 2007

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Independent Accountants' Review 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 sheet of KT&G Corporation and subsidiaries (collectively, the "Company") as of September 30, 2008, and the related consolidated statements of income for the three- and nine-month periods, and the consolidated statements of changes in equity and cash flows for the nine-month periods ended September 30, 2008 and 2007. 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 Semi-annual 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, 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, 2007 and the related consolidated statements of income, changes in equity and cash flows for the period then ended, which are not accompanying this report, were audited by us and our report thereon, dated February 25, 2008, expressed an unqualified opinion on those statements. The accompanying consolidated balance sheet of the Company as of December 31, 2007, 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 nine-month period ended September 30, 2008 have been translated into United States dollars solely for the convenience of the reader. We have reviewed the translation and nothing has come to our attention to suggest that the financial statements expressed in Korean Won have not been translated into dollars on the basis set forth in note 3 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 2(a) 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, changes in equity and cash flows in accordance with accounting principles and practices generally accepted in countries other than the Republic of Korea. In addition, the procedures and practices utilized in the Republic of Korea to 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 24 to the consolidated financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩759 million for the harmful effects of smoking. The final outcome of these lawsuits cannot be predicted at present. Accordingly, no provisions have been made in the accompanying consolidated financial statements.

As discussed in notes 11 and 24 to the consolidated financial statements, the Company maintains a contract with the farmers under which they are to grow green ginseng and, once the product becomes nine years old, sell the ginseng to the Company. As of September 30, 2008 and December 31, 2007, the balance of advance payments paid to the farmers in accordance with the contract amounted to ₩178,998 million and ₩116,289 million, respectively.

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

Seoul, Korea
November 1, 2008

<p>This report is effective as of November 1, 2008, 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.</p>

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets
(Unaudited)

As of September 30, 2008 and December 31, 2007

	Note	2008		2007
		Korean Won	U.S. dollars (note 3)	Korean Won
<i>In millions of Won and thousands of US dollars</i>				
Assets				
Cash and cash equivalents	23	₩ 141,600	\$ 119,222	₩ 137,687
Short-term financial instruments		1,000	842	1,000
Trade accounts receivable, net of allowance for doubtful accounts of ₩23,981 in 2008 and ₩11,420 in 2007	5,10,23,24	462,299	389,238	369,804
Other receivables, net of allowance for doubtful accounts of ₩5,962 in 2008 and ₩5,911 in 2007	23	47,742	40,197	34,055
Inventories	6,14	1,224,219	1,030,748	1,317,705
Current portion of long-term loans, net of allowance for doubtful accounts of ₩0 in 2008 and ₩123 in 2007	10	19,467	16,391	19,504
Current deferred tax assets	32	8,832	7,436	17,605
Advance payments, net of allowance for doubtful accounts of ₩84 in 2008 and ₩85 in 2007	11,24	85,225	71,757	23,716
Other current assets	7	26,042	21,927	10,920
Total current assets		<u>2,016,426</u>	<u>1,697,758</u>	<u>1,931,996</u>
Available-for-sale securities	8	336,308	283,159	257,098
Equity method investment securities	9	2,486	2,093	35,969
Long-term loans	10	99,148	83,479	99,178
Guarantee deposits paid		56,276	47,382	51,162
Guarantee deposits for membership		23,080	19,432	22,137
Long-term deposits in Escrow Fund	23,24	100,384	84,519	66,633
Property, plant and equipment, net	12,13,14,15	1,617,638	1,361,992	1,559,289
Intangible assets, net	16,17	5,784	4,870	8,659
Long-term advance payments, net of allowance for doubtful accounts of ₩1,411 in 2008 and ₩934 in 2007	11,24	142,465	119,951	96,493
Deferred income tax assets	32	1,433	1,207	1,765
Other non-current assets	18	2,921	2,459	3,723
Total non-current assets		<u>2,387,923</u>	<u>2,010,543</u>	<u>2,202,106</u>
Total assets		<u>₩ 4,404,349</u>	<u>\$ 3,708,301</u>	<u>₩ 4,134,102</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets, Continued
(Unaudited)

As of September 30, 2008 and December 31, 2007

*In millions of Won
and thousands of US dollars,
except share data*

	Note	2008		2007
		Korean Won	U.S. dollars (note 3)	Korean Won
Liabilities				
Trade accounts payable	23	₩ 42,402	\$ 35,701	₩ 15,202
Short-term borrowings	15,20,24	35,200	29,637	38,097
Advance receipts		8,243	6,940	6,127
Value added tax payable		146,121	123,028	128,985
Accrued expenses		38,299	32,246	17,343
Other payables	23	108,984	91,761	105,693
Income taxes payable	32	102,642	86,421	220,428
Tobacco excise and other taxes payable		168,784	142,110	181,734
Other current liabilities	19	30,698	25,848	17,297
Total current liabilities		681,373	573,692	730,906
Long-term borrowings	15,21,24	2,544	2,142	2,733
Retirement and severance benefits	22	116,711	98,266	86,392
Guarantee deposits received		22,965	19,336	25,051
Deferred income tax liabilities	32	154,195	129,827	124,535
Reserve for sales returns		661	557	894
Reserve for lawsuit		364	306	364
Total non-current liabilities		297,440	250,434	239,969
Total liabilities		978,814	824,126	970,875
Stockholders' equity				
Common stock of ₩5,000 par value				
Authorized - 800,000,000 shares				
Issued - 140,742,497 shares in 2008 and 143,442,497 shares in 2007				
Outstanding - 129,705,326 shares in 2008 and 130,839,907 shares in 2007		954,959	804,041	954,959
Capital surplus		471,144	396,686	465,866
Capital adjustments	25	(306,751)	(258,274)	(414,947)
Accumulated other comprehensive income	26	52,544	44,240	2,496
Retained earnings	27	2,233,706	1,880,699	2,134,736
Minority interest in consolidated subsidiaries		19,933	16,783	20,117
Total stockholders' equity		3,425,535	2,884,175	3,163,227
Total liabilities and stockholders' equity		₩ 4,404,349	\$ 3,708,301	₩ 4,134,102

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Statements of Income
(Unaudited)

For the nine-month periods ended September 30, 2008 and 2007

	Note	2008		2007	
		Korean Won	U.S. dollars (note 3)	Korean Won	
<i>In millions of Won and thousands of US dollars, except earnings per share</i>					
Sales	10,28,36	₩ 2,453,069	\$ 2,065,394	₩	2,267,380
Cost of sales	10,28,30,31	1,002,035	843,677		977,474
Gross profit		1,451,034	1,221,717		1,289,906
Selling, general and administrative expenses	10,29,30,31	593,282	499,522		529,223
Operating income	36	857,752	722,195		760,683
Interest income		18,306	15,413		30,060
Interest expense		(2,512)	(2,115)		(3,707)
Other bad debt expense		(1,108)	(933)		(786)
Reversal of allowance for doubtful allowance		587	494		404
Gain (loss) on foreign currency transactions, net		15,318	12,897		(599)
Gain (loss) on foreign currency translation, net		46,448	39,108		(1,849)
Gain on sale of property, plant and equipment, net		11,801	9,936		6,365
Loss on impairment of available-for-sale securities	8	-	-		(2,163)
Loss on impairment of property, plant and equipment		(429)	(361)		(2,178)
Provision for Tobacco Production Stabilization Fund		-	-		(13,570)
Gain (loss) on prior period adjustment	2	2,613	2,200		(20,959)
Gain on valuation of equity method investment securities, net	9	187	157		648
Donations	31	(26,468)	(22,285)		(15,523)
Other, net		(6,400)	(5,388)		3,506
Other income		58,343	49,123		(20,351)
Income before income taxes		916,095	771,318		740,332
Income taxes	32	267,093	224,883		228,387
Net income		₩ 649,002	\$ 546,435	₩	511,945
Controlling Interest in net income	38	649,186	546,590		526,755
Minority interest in losses of consolidated subsidiaries	38	(184)	(155)		(14,810)
Earnings per share					
Basic earnings per share	33	₩ 4,972	\$ 4.19	₩	3,973

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income

(Unaudited)

For the three-month periods ended September 30, 2008 and 2007

	Note	2008		2007	
		Korean Won	U.S. dollars (note 3)	Korean Won	
<i>In millions of Won and thousands of US dollars except earnings per share</i>					
Sales	10,28	₩ 852,031	\$ 717,379	₩ 805,922	
Cost of sales	10,28,30,31	349,465	294,237	338,099	
Gross profit		502,566	423,142	467,823	
Selling, general and administrative expenses	10,29,30,31	215,163	181,159	179,836	
Operating income		287,403	241,983	287,987	
Interest income		6,339	5,337	10,240	
Interest expense		(687)	(578)	(1,276)	
Other bad debt expense		(604)	(509)	(377)	
Reversal of allowance for doubtful accounts		-	-	17,898	
Loss on impairment of available-for-sale securities	8	-	-	(13)	
Gain (loss) on foreign currency transactions, net		8,454	7,118	(407)	
Gain (loss) on foreign currency translation, net		30,219	25,443	(1,330)	
Gain on sale of property, plant and equipment, net		5,838	4,915	1,385	
Loss on impairment of property, plant and equipment		(429)	(361)	(2,178)	
Provision for Tobacco Production Stabilization Fund		-	-	(4,634)	
Gain on valuation of equity method investment securities, net	9	267	225	399	
Gain (loss) on prior period adjustment	2	2,613	2,200	(20,959)	
Donations	31	(8,293)	(6,982)	(8,577)	
Other, net		(4,494)	(3,784)	(1,417)	
Other income		39,223	33,024	(11,246)	
Income before income taxes		326,626	275,007	276,741	
Income taxes	32	96,013	80,839	80,622	
Net income		₩ 230,614	\$ 194,168	₩ 196,119	
Controlling interest in net income	38	230,523	194,092	198,725	
Minority interest in losses of consolidated subsidiaries	38	90	76	(2,606)	
Earnings per share					
Basic earnings per share	33	₩ 1,768	\$ 1.49	₩ 1,502	

See accompanying notes to consolidated financial statements.

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

For the nine-month periods ended September 30, 2008 and 2007

		Korean Won						
<i>In millions of Won</i>		Capital stock	Capital surplus	Capital adjust- ments	Accumu- lated other compre- hensive income	Retained earnings	Minority interest	Total stock holders' equity
Balance at January 1, 2007	₩	954,959	335,350	(321,904)	15,791	2,061,349	20,218	3,065,763
Dividends		-	-	-	-	(319,712)		(319,712)
Net income		-	-	-	-	526,755	(14,810)	511,945
Increase in unrealized gain on valuation of available-for-sale securities		-	-	-	7,841	-	-	7,841
Decrease in unrealized gain on valuation of equity method investment securities		-	-	-	(621)	-	-	(621)
Reacquisition of treasury stock		-	-	(269,410)	-	-	-	(269,410)
Retirement of treasury stock		-	-	269,410	-	(269,410)	-	-
Compensation by treasury stock		-	99,465	74,390	-	-	-	173,855
Changes in translation adjustments		-	-	-	802	-	-	802
Other		-	-	-	-	(97)	(77)	(174)
Balance at September 30, 2007	₩	<u>954,959</u>	<u>434,815</u>	<u>(247,514)</u>	<u>23,813</u>	<u>1,998,885</u>	<u>5,331</u>	<u>3,170,289</u>

		Korean Won						U.S. dollars (note 3)	
<i>In millions of Won and thousands of US dollars</i>		Capital stock	Capital surplus	Capital adjust- ments	Accumu- lated other compre- hensive income	Retained earnings	Minority interest	Total stock holders' equity	Total stock holders' equity
Balance at January 1, 2008	₩	954,959	465,866	(414,947)	2,496	2,134,736	20,117	3,163,227	2,663,322
Dividends		-	-	-	-	(340,449)	-	(340,449)	(286,646)
Net income		-	-	-	-	649,186	(184)	649,002	546,437
Increase in unrealized gain on valuation of available-for-sale securities		-	-	-	43,436	-	-	43,436	36,572
Reacquisition of treasury stock		-	-	(108,889)	-	-	-	(108,889)	(91,681)
Retirement of treasury stock		-	-	209,767	-	(209,767)	-	-	-
Compensation by treasury stock		-	4,375	2,377	-	-	-	6,752	5,685
Changes in translation adjustments		-	-	-	7,515	-	-	7,515	6,327
Increase in unearned stock compensation		-	-	4,941	-	-	-	4,941	4,159
Other		-	903	-	(903)	-	-	-	-
Balance at September 30, 2008	₩	<u>954,959</u>	<u>471,144</u>	<u>(306,751)</u>	<u>52,544</u>	<u>2,233,706</u>	<u>19,933</u>	<u>3,425,535</u>	<u>2,884,175</u>

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited)

For the nine-month periods ended September 30, 2008 and 2007

	2008		2007	
	Korean Won	U.S. dollars (note 3)	Korean Won	Korean Won
<i>In millions of Won and thousands of US dollars</i>				
Cash flows from operating activities				
Net income	₩ 649,002	\$ 546,435	₩ 511,945	
Adjustments for:				
Depreciation and amortization	122,248	102,928	114,814	
Loss (gain) on valuation of inventories, net	(15,312)	(12,892)	5,175	
Bad debt expense	12,977	10,926	4,027	
Loss on impairment of available-for-sale securities	-	-	2,163	
Gain on valuation of equity method investment securities, net	(187)	(157)	(648)	
Loss (gain) on foreign currency translation, net	(46,376)	(39,047)	1,845	
Other bad debt expense	1,108	933	786	
Reversal of allowance for doubtful accounts	(587)	(494)	(404)	
Provision for retirement and severance benefits	47,918	40,346	29,017	
Loss (gain) on prior period adjustment	2,613	2,200	20,959	
Amortization of present value discounts	-	-	(9,761)	
Provision for Tobacco Production Stabilization Fund	-	-	13,570	
Other, net	(1,804)	(1,520)	(9,378)	
	117,372	98,823	172,165	
Change in assets and liabilities:				
Trade accounts receivable	(78,534)	(66,123)	(88,823)	
Other receivables	(10,830)	(9,118)	(14,699)	
Accrued income	(331)	(279)	(3,404)	
Advance payments	(57,708)	(48,588)	(83,924)	
Prepaid expenses	(13,733)	(11,563)	(17,405)	
Inventories	113,649	95,688	232,721	
Long-term advance payments	(48,165)	(40,553)	(36,536)	
Trade accounts payable	20,406	17,181	8,587	
Other payables	3,234	2,723	12,889	
Advance receipts	2,116	1,782	8,190	
Withholdings	7,138	6,010	1,902	
Value added tax payable	17,135	14,427	19,538	
Accrued expenses	26,938	22,681	12,652	
Tobacco excise tax and dues payable	(12,950)	(10,903)	550,298	
Income taxes payable	(117,854)	(99,229)	35,887	
Deferred income taxes, net	20,217	17,022	3,866	
Deposit for severance benefits trust	(1,448)	(1,219)	2,009	
Payments of retirement and severance benefits	(8,801)	(7,410)	(17,800)	
Others, net	(1,385)	(1,165)	(925)	
Net cash provided by operating activities	₩ 625,468	\$ 526,621	₩ 1,309,133	

See accompanying notes to consolidated financial statements.

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

For the nine-month periods ended September 30, 2008 and 2007

*In millions of Won
and thousands of US dollars*

	2008		2007	
	Korean Won	U.S. dollars (note 3)	Korean Won	
Cash flows from investing activities				
Proceeds from sale of available-for-sale securities	₩ 328	\$ 276	₩ 881	
Proceeds from sale of equity method investment securities	-	-	669	
Decrease in short-term financial instruments	-	-	11,940	
Decrease (increase) in short-term and long-term loans	86	72	(8,062)	
Increase in guarantee deposits, net	(5,124)	(4,314)	(6,731)	
Proceeds from sale of property, plant & equipment	18,920	15,930	15,599	
Purchases of available-for-sale securities	(20,527)	(17,283)	(219,481)	
Increase in long-term deposit in Escrow Fund	(13,394)	(11,277)	(17,500)	
Purchases of property, plant & equipment	(147,869)	(124,500)	(181,253)	
Purchases of intangible assets	(360)	(303)	(1,289)	
Decrease in other investment assets	791	666	1,465	
Other, net	(871)	(733)	(406)	
Net cash used in investing activities	<u>(168,020)</u>	<u>(141,467)</u>	<u>(404,168)</u>	
Cash flows from financing activities				
Decrease in guarantee deposits received, net	(2,054)	(1,729)	(3,360)	
Proceeds from short-term borrowings	79,055	66,561	166,610	
Proceeds from long-term borrowings	22	19	1,541	
Disposal of treasury stock	-	-	201,901	
Repayment of short-term borrowings	(84,913)	(71,494)	(172,809)	
Repayment of current portion of long-term borrowings	(140)	(118)	-	
Reacquisition of treasury stock	(108,889)	(91,681)	(269,410)	
Payment of dividends	(340,449)	(286,646)	(319,712)	
Net cash used in financing activities	<u>(457,368)</u>	<u>(385,087)</u>	<u>(395,239)</u>	
Net increase (decrease) in cash and cash equivalents from change of subsidiaries in consolidated financial statements	3,836	3,230	(888)	
Increase in cash and cash equivalents due to merger	-	-	415	
	<u>3,836</u>	<u>3,230</u>	<u>(473)</u>	
Net Increase in cash and cash equivalents	3,913	3,295	509,253	
Cash and cash equivalents at beginning of period	137,687	115,927	201,869	
Cash and cash equivalents at end of period	<u>₩ 141,600</u>	<u>\$ 119,222</u>	<u>₩ 711,122</u>	

See accompanying notes to consolidated financial statements.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

1 Organization and Description of Business

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

As of September 30, 2008, the Parent Company has four manufacturing plants, including the Shin Tan Jin plant, and 14 local headquarters and 168 branches for the sale of tobacco throughout the country. Also, the Parent Company has the Gimcheon plant for fabrication of leaf tobacco and the Chunahn printing plant for the manufacturing of packaging.

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

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

The ownership of the Parent Company's issued common stock at September 30, 2008 was held as follows:

Stockholder	Number of shares	Percentage of ownership
Industrial Bank of Korea	9,510,485	6.76%
Employee Stock Ownership Association	7,590,405	5.39%
Treasury stock	11,037,171	7.84%
Others	112,604,436	80.01%
	140,742,497	100.00%

The Parent Company has, thus far, reacquired and retired 50,249,400 shares of treasury stock. Accordingly, as of September 30, 2008, the Parent Company's common stock differs from the aggregate par value of issued shares by ₩251,247 million.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(a) Basis of Presenting Consolidated Financial Statements

KT&G Corporation and the controlled subsidiaries (hereinafter referred to collectively as the "Company") maintains its accounting records in Korean Won and prepares statutory consolidated financial statements in the Korean language in conformity with accounting principles generally accepted in the Republic of Korea. Certain accounting principles applied by the Company that conform with financial accounting standards and accounting principles in the Republic of Korea may not conform with generally accepted accounting principles in other countries. Accordingly, these financial statements are intended solely for use by 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.

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

- (i) The consolidated financial statements include the accounts of KT&G and the following controlled subsidiaries as of September 30, 2008 and December 31, 2007. Controlled subsidiaries include entities majority-owned by either KT&G or a controlled subsidiary and other entities where KT&G or its controlled subsidiary owns more than 30% of total outstanding common stock of an investee company and is the largest shareholder. All significant intercompany balances and transactions have been eliminated in consolidation.

<u>Subsidiary</u>	<u>year of establish- ment</u>	<u>Number of shares</u>	<u>Percentage of ownership</u>	<u>Primary business</u>
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") (*4)	1962	65,655,051	55.50%	Manufacturing pharmaceutical products
Tae-a Industry Co., Ltd. ("TAI") (*2)	1972	150,000	100.00%	Manufacturing subsidiary material for tobacco
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. ("KTMST") (*2) (*3)	2003	8,999,888	99.99%	Manufacturing and selling tobacco in Turkey

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

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

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

(*4) Yungjin Pharm. Ind. Co., Ltd. restated its financial statements as of and for the year ended December 31, 2006 due to adjustments for the accounting errors made in year 2006 and prior periods resulting in an increase in accumulated deficit by ₩20,959 million. However, as the effect of the adjustments on the consolidated financial statements was immaterial, the adjusted loss has been charged to current results of operations for the year period ended September 30, 2007.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(a) Basis of Presenting Consolidated Financial Statements, Continued

- (ii) Significant account balances which occurred in the normal course of business with and between subsidiaries as of September 30, 2008 and December 31, 2007 are summarized as follows (these amounts have been eliminated in consolidation):

In millions of Won

<u>Transaction Party</u>		<u>Balance Sheet Account</u>	<u>September 30, 2008</u>	<u>December 31, 2007</u>
KT&G	KTMST	Trade accounts receivable	₩ 1,262	-
KT&G	KTMST	Advance payments	19,044	-
KT&G	KGC	Other receivables	1,086	-
KGC	KT&G	Trade accounts receivable	632	270
KGC	KT&G	Guarantee deposits	2,043	2,043
KGC	KT&G	Prepaid expense	58	336
KGC	KGHK	Trade accounts receivable	5,478	5,037
KGC	YJPI	Trade accounts receivable	321	98
YJPI	KGC	Guarantee deposits	212	212
TAI	KT&G	Trade accounts receivable	1,375	-

- (iii) Significant transactions which occurred in the normal course of business with and between consolidated subsidiaries for the nine-month periods ended September 30, 2008 and 2007 are summarized as follows (these amounts have been eliminated in consolidation):

In millions of Won

<u>Transaction Party</u>		<u>Income Statement Account</u>	<u>2008</u>	<u>2007</u>
KT&G	KGC	Sales	₩ 9,935	1,047
KT&G	YJPI	Sales	25	65
KT&G	KTMST	Sales	2,500	-
KT&G	KGC	Other income	697	10,303
KT&G	YJPI	Other income	6	1
KGC	KT&G	Sales	1,943	1,662
KGC	YJPI	Sales	1,362	746
KGC	KGHK	Sales	14,936	10,786
KGC	TAI	Sales	22	15
YJPI	KT&G	Sales	5	94
YJPI	KGC	Sales of property, Plant & equipment	-	9,130
TAI	KT&G	Sales	11,387	9,632

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(b) Cash Equivalents

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

(c) Short-term Deposits

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

(d) Allowance for Doubtful Accounts

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

(e) Inventories

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-progress; using the moving-average method for raw materials and supplies; and using the specific identification method for goods-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. The amount of any write-down of inventories to net realizable value due to obsolescence or excess inventory and other losses of inventories occurring in the normal course of business are recognized as cost of goods sold and such valuation losses are deducted from the inventories as allowance for valuation losses. The Company recognized loss and reversal of loss on valuation of inventories amounting to ₩4,618 million and ₩19,930 million, respectively, for the nine-month period ended September 30, 2008. Also, the estimated amounts of inventories in current assets which are not expected to be realized within a period are ₩155,972 million and ₩319,217 million, respectively, as of September 30, 2008 and December 31, 2007

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.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(f) Investment in Securities (excluding investments in associates, subsidiaries and joint ventures)

Classification

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

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

Initial recognition

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

Subsequent measurement and income recognition

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

Fair value information

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

Presentation

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

Impairment

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

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized and a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized in the asset in prior years. For financial assets measured at amortized cost and available-for-sale assets that are debt securities, the reversal is recognized in profit or loss. For available-for-sale financial assets that are equity securities, the reversal is recognized directly in equity.

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(g) Investment Securities under the Equity Method of Accounting

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

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

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

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

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

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

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(h) Property, Plant and Equipment

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

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

Depreciation is computed as follows:

	<u>Depreciation method</u>	<u>Useful lives (years)</u>
Buildings	Straight-line method	10 to 60
Structures	Straight-line method	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 interest cost and other financial charges on borrowings associated with the manufacture, purchase, or construction of property, plant and equipment as an expense in the period in which they are incurred.

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

Youngjin Pharm. Ind. Co., Ltd. changed its depreciation method of some buildings, structures and machinery from declining-balance method to straight-line method and recorded the effect of change in the amount of ₩2,613 as other income since the effect on the consolidated financial statements was judged to be immaterial.

(i) Goodwill

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(j) Intangible Assets, Continued

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

(i) Research and Development Costs

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

(ii) Other Intangible Assets

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

(k) Retirement and Severance Benefits

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

(l) Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at the balance sheet date, with the resulting gains or losses recognized in current results of operations. Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at ₩1187.7 to US\$1, the rate of exchange on September 30, 2008 that is permitted by the Financial Accounting Standards. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Korean Won at the foreign exchange rate on the date of the transaction.

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(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) Revenue Recognition

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

Tobacco products sold

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

Lotting-out construction contracts

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

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

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

(o) Income Taxes

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

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

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

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

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

(o) Income Taxes, Continued

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

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

(p) 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.

(q) Prior Period Adjustments

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

(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) Share-based Payments

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
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September 30, 2008 and 2007

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

(t) Derivatives

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

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

Hedge accounting

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

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

Fair value hedge

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

Cash flow hedge

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

Derivatives that do not qualify for hedge accounting

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

Separable embedded derivatives

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

KT&G CORPORATION AND SUBSIDIARIES
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September 30, 2008 and 2007

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

(u) 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.

(v) Minority Interest in Consolidated Subsidiaries

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

3 Basis of Translating Consolidated Financial Statements

The consolidated financial statements are expressed in Korean Won and, solely for the convenience of the reader, have been translated into United States dollars at the rate of ₩1187.7 to US\$1, the basic exchange rate on September 30, 2008. This translation should not be construed as a representation that any or all of the amounts shown could be converted into U.S. dollars at this or any other rate.

4 Restricted Deposits

Financial instruments restricted in use as security for maintaining checking accounts as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Long-term financial instruments	₩ <u>8</u>	<u>8</u>

5 Transfers of Trade Accounts Receivable

Certain of export trade accounts and notes receivable transferred to and discounted with third parties as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Export trade accounts receivable	₩ 137	2,795
Notes receivable	<u>6,560</u>	<u>7,056</u>
	₩ <u>6,697</u>	<u>9,851</u>

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

6 Inventories

Inventories as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Merchandise, net of allowance for valuation losses	₩ 939	1,107
Finished goods, net of allowance for valuation losses	159,438	134,164
Semi-finished goods	11,671	20,170
Work-in-progress, net of allowance for valuation losses	188,591	259,059
Raw materials, net of allowance for valuation losses	720,955	804,741
Subsidiary material, net of allowance for valuation losses	905	548
Supplies	21,834	21,856
By-products	2,867	2,641
Unsold buildings (note 28)	85,941	52,150
Sites for building lotting-out construction (notes 13 and 28)	14,519	13,204
Goods-in-transit	<u>16,558</u>	<u>8,065</u>
	<u>₩ 1,224,219</u>	<u>1,317,705</u>

7 Other Current Assets

Other current assets as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Accrued income	₩ 658	326
Prepaid expenses	23,135	9,374
Prepaid income taxes	103	34
Short-term loans, net of allowance for doubtful accounts of ₩125 in 2008 and ₩0 in 2007	1,073	1,094
Available-for-sale securities (note 8)	<u>1,073</u>	<u>92</u>
	<u>₩ 26,042</u>	<u>10,920</u>

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
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September 30, 2008 and 2007

8 Available-for-sale Securities

Available-for-sale securities as of September 30, 2008 and December 31, 2007 are summarized as follows:

(a) Equity securities (non-current)

<i>In millions of Won, except owned shares and percentage of ownership</i>	Number of shares	Percentage of ownership	Acquisition cost	Fair value	Book value	
					September 30, 2008	December 31, 2007
Marketable securities:						
Yonhap Television News (YTN)	8,380,000	19.95%	₩ 5,102	39,805	39,805	28,366
Crystal Genomics Co., Ltd.	172,187	1.67%	3,022	1,715	1,715	1,791
Oscotech, Inc.	230,770	3.51%	2,250	1,027	1,027	1,396
Shinhan Financial Group	3,500,000	0.88%	205,532	146,650	146,650	187,250
REXAHN Pharmaceuticals, Inc. (*1)	4,642,858	8.28%	5,158	7,114	7,114	-
Celltrion, Inc. (*1)	13,030,810	12.23%	21,245	108,807	108,807	-
			<u>242,309</u>	<u>305,118</u>	<u>305,118</u>	<u>218,803</u>
Non-marketable securities:						
Celltrion, Inc. (*1)	-	-	-	-	-	21,245
Nexgen Biotechnologies, Inc. (*3)	1,000,000	11.84%	2,150	-	-	-
Cosmo Tobacco Co., Ltd. (*3)	480,000	40.00%	2,540	-	-	-
Innodis, Inc.	110,000	19.64%	55	55	55	55
REXAHN Pharmaceuticals, Inc. (*1)	-	-	-	-	-	5,158
Lifenza, Inc. (*3)	29,047	13.01%	1,600	-	-	-
Korea Islet Transplantation Institute, Inc. (*2)	110,500	48.25%	2,000	2,000	2,000	2,000
KT&G Mongolia LLC (*4)	-	-	-	-	-	201
Korea Tabacos do Brasil Ltda. (*2)	(*6)	99.90%	394	394	394	394
Genematrix, Inc.	300,000	10.14%	1,500	1,500	1,500	1,500
Litepharmtech, Inc. (*2)	77,667	29.46%	1,830	1,830	1,830	1,830
Hurum, Inc.	7,800	9.75%	39	39	39	39
Mazence Co., Ltd. (formerly, MD Bioalpha Co., Ltd.)	197,556	6.86%	733	733	733	733
OCT USA, Inc.	48,780	19.97%	927	927	927	927
Dream Hub PFV Co., Ltd.	3,000,000	1.50%	15,000	15,000	15,000	75
Migami, Inc.	4,286,000	3.77%	2,830	2,830	2,830	-
KT&G Pars (*2)	459,998	99.99%	479	479	479	-
KT&G Rus L.L.C. (*2)	(*6)	99.00%	793	793	793	-
Korea Carbon Finance, Inc. (*2)	100,000	20.00%	500	500	500	-
SJ Biomed Corporation	285,714	16.00%	1,000	1,000	1,000	-
The Korea Economic Daily	287	0.00%	5	5	5	5
Ddrug Co., Ltd. (*5)	-	-	-	-	-	4
Husis Co., Ltd. (*3)	700,000	6.90%	210	-	-	-
Yungjin Co., Ltd. (*3)	16,760	41.90%	168	-	-	-
Yungjin Health Co., Ltd. (*3)	17,900	29.80%	90	-	-	-
			<u>34,843</u>	<u>28,085</u>	<u>28,085</u>	<u>34,166</u>
Total			₩ <u>277,152</u>	<u>333,203</u>	<u>333,203</u>	<u>252,969</u>

(*1) As REXAHN Pharmaceuticals, Inc. was listed on American Stock Exchange in the period ended September 30, 2008, REXAHN Pharmaceuticals, Inc. is recorded at the reasonably adjusted value of the market price established in American Stock Exchange. Celltrion, Inc. was listed on Korean Securities Dealers Automated Quotations in the period ended September 30, 2008, Celltrion, Inc. was recorded at fair value.

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8 Available-for-sale Securities, Continued

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

- (*2) Investments in small affiliates are accounted for under the cost method for investments since the effect on their financial statements of applying the equity method is not material.
- (*3) In the prior period, the Company wrote off its investments in Nexgen Biotechnologies, Inc., Lifenza, Inc., Cosmo Tobacco Co., Ltd., Husis Co., Ltd., Yungjin Co., Ltd. and Yungjin Health Co., Ltd. as their decline in value was judged to be other than temporary. Other than the above securities, non-marketable securities were recorded at cost since fair value is not available or readily determinable.
- (*4) The liquidation process of KT&G Mongolia LLC was completed in the period ended September 30, 2008, the Company recorded a gain on sale of available-for-sale securities of ₩80 million.
- (*5) The Company disposed of its investment in Ddrug Co., Ltd. and recognized a loss on sale of available-for-sale securities of ₩4 million in the period ended September 30, 2008.
- (*6) Stock certificates are not issued.

(b) Debt securities

<i>In millions of Won</i>	Interest rate per annum	Acquisition cost	Fair value	Book value	
				September 30, 2008	December 31, 2007
Current assets:					
Government and municipal bonds	2.5 ~ 4.0%	₩ 73	73	73	92
Oscotech, Inc.	10.0%	1,000	1,000	1,000	-
		<u>1,073</u>	<u>1,073</u>	<u>1,073</u>	<u>92</u>
Non-current assets:					
Government and municipal bonds	2.5 %	2,105	2,105	2,105	2,129
Oscotech, Inc.	-	-	-	-	1,000
Litepharmtech, Inc.	8.0%	1,000	1,000	1,000	1,000
		<u>3,105</u>	<u>3,105</u>	<u>3,105</u>	<u>4,129</u>
		<u>₩ 4,178</u>	<u>4,178</u>	<u>4,178</u>	<u>4,221</u>

- (*) The Company recorded an interest income of ₩15 million for the period ended September 30, 2008.

(c) Changes in unrealized gains

- (i) Changes in unrealized gains of valuation of available-for-sale securities for the nine-month period ended September 30, 2008 are summarized as follows:

<i>In millions of Won</i>	Amount including tax effect	Tax effect	Amount, net of tax effect
Beginning balance	₩ 2,897	(797)	2,100
Changes in unrealized gain	<u>59,912</u>	<u>(16,476)</u>	<u>43,436</u>
Ending balance	<u>₩ 62,809</u>	<u>(17,273)</u>	<u>45,536</u>

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8 Available-for-sale Securities, Continued

(c) Changes in unrealized gains, Continued

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

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

9 Equity Method Investment Securities

(a) Investments in companies accounted for using the equity method as of September 30, 2008 were as follows:

In millions of Won, except percentage of ownership

<u>Company</u>	<u>Percentage of ownership</u>	<u>Cost</u>	<u>Market value or net assets</u>	<u>Balance at September 30, 2008</u>
Unlisted				
KGC Sales Co., Ltd.	99.99%	₩ 1,500	2,828	2,486

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

In millions of Won, except percentage of ownership

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

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

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9 Equity Method Investment Securities, Continued

- (b) Details of eliminated unrealized gains from inter-company transactions for the nine-month period ended September 30, 2008 are summarized as follows:

<i>In millions of Won</i>	2008			
	<u>Beginning balance</u>	<u>Increase</u>	<u>Realized amount</u>	<u>Ending balance</u>
KGC Sales Co., Ltd.	₩ <u>20</u>	<u>342</u>	<u>(20)</u>	<u>342</u>

Details of eliminated unrealized gains from inter-company transactions for the year ended December 31, 2007 are summarized as follows:

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

- (c) Changes in the opening and closing balances of investments in companies accounted for using the equity method for the nine-month period ended September 30, 2008 were as follows:

In millions of Won except percentage of ownership

Company	Percentage of ownership	2008			
		Balance at January 1, 2008	Net Income	Other Decrease (*)	Balance at September 30, 2008
KGC Sales Co., Ltd.	100.00%	₩ 2,299	187	-	2,486
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	99.99%	<u>33,670</u>	-	<u>(33,670)</u>	-
		₩ <u>35,969</u>	<u>187</u>	<u>(33,670)</u>	<u>2,486</u>

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

Changes in the opening and closing balances of investments in companies accounted for using the equity method for the year ended December 31, 2007 were as follows:

In millions of Won except percentage of ownership

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

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

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9 Equity Method Investment Securities, Continued

- (d) Summarized financial information of equity method investment securities as of and for the nine-month period ended September 30, 2008 is as follows:

In millions of Won

<u>Affiliate</u>		<u>Total assets</u>	<u>Total liabilities</u>	<u>Sales</u>	<u>Net income</u>
KGC Sales Co., Ltd.	₩	7,844	5,016	11,531	509

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

In millions of Won

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

10 Transactions and Balances with Related Companies

- (a) The Company's subsidiaries as of September 30, 2008 were as follows:

<u>Controlled subsidiary(*)</u>	<u>Ownership(%)</u>
Cosmo Tabacco Co., Ltd.	40.00%
Korea Tabacos do Brasil Ltda.	99.90%
Korea Islet Transplantation Institute, Inc.	48.25%
KGC Sales Co., Ltd.	100.00%
Yungjin Distribution Co., Ltd.	41.90%
KT&G Pars	99.99%
KT&G Rus L.L.C.	99.00%

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

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10 Transactions and Balances with Related Companies, Continued

(b) Significant transactions and account balances which occurred in the normal course of business with related companies for the three- and nine-month periods ended September 30, 2008 and 2007 and as of September 30, 2008 and December 31, 2007 are summarized as follows:

(i) Sales

<i>In millions of Won</i>	2008		2007	
	Three months	Nine months	Three months	Nine months
KGC Sales Co., Ltd.	₩ 4,020	9,739	3,537	10,386
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	-	-	293	372
KT&G Monglia LLC.	-	-	468	1,148
KT&G USA, Inc.	-	-	-	1,694
KT&G Pars	269	555	-	-
	₩ <u>4,289</u>	<u>10,294</u>	<u>4,298</u>	<u>13,600</u>

(ii) Purchases and other expenses

<i>In millions of Won</i>	2008		2007	
	Three months	Nine months	Three months	Nine months
Korea Tabacos do Brasil Ltda.	₩ 54	129	58	106
	₩ <u>54</u>	<u>129</u>	<u>58</u>	<u>106</u>

(iii) Due from affiliates

<i>In millions of Won</i>	September 30, 2008			December 31, 2007		
	Trade accounts receivable	Other	Total	Trade accounts receivable	Other	Total
KT&G Mongolia LLC	₩ -	-	-	316	238	554
KT&G Pars	586	2,937	3,523	-	-	-
KGC Sales Co., Ltd.	3,086	-	3,086	3,158	-	3,158
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	-	-	-	1,127	-	1,127
Yungjin Health Food Co., Ltd.	4,310	-	4,310	4,310	-	4,310
	₩ <u>7,982</u>	<u>2,937</u>	<u>10,919</u>	<u>8,911</u>	<u>238</u>	<u>9,149</u>

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10 Transactions and Balances with Related Companies, Continued

(c) Due from the stockholders, directors and employees as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Loans for employee housing and tuition	₩ 51,791	31,987
Loans to employee stock ownership association	10,340	37,803
Other	49,856	46,004
	<u>₩ 111,987</u>	<u>115,794</u>

(d) Details of compensation to top executives for the nine-month period ended September 30, 2008 are summarized as follows:

<i>In millions of Won</i>	Amount
Short-term payroll	₩ 8,506
Post-retirement payments	12,039
	<u>₩ 20,545</u>

11 Advance Payments

The Company maintains a contract with the farmers under which they are to grow green ginseng and sell the ginseng to the Company once the product becomes nine years old. As of September 30, 2008 and December 31, 2007, advance payments paid to the farmers in accordance with the contract are as follows:

In millions of Won

Classification	Account	September 30, 2008	December 31, 2007
Two-year old ginseng	Long-term advance payments	₩ 47,666	-
Three-year old ginseng	Long-term advance payments	35,236	35,253
Four-year old ginseng	Long-term advance payments	31,602	31,749
Five-year old ginseng	Long-term advance payments	26,582	26,417
		141,086	93,419
Six-year old ginseng	Short-term advance payments	37,912	22,870
Total		<u>₩ 178,998</u>	<u>116,289</u>

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12 Property, Plant and Equipment

Property, plant and equipment at September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Property, plant and equipment at cost	₩ 2,609,134	2,470,193
Accumulated depreciation	(989,942)	(908,684)
Accumulated impairment losses	(1,554)	(2,220)
Property, plant and equipment, net	₩ 1,617,638	1,559,289

(a) Changes in property, plant and equipment for the nine-month period ended September 30, 2008 were as follows:

<i>In millions of Won</i>	January 1, 2008	Change of Subsidiaries	Acquisition	Disposal	Depreciation	Others (*2)	September 30, 2008
Land	₩ 431,728	2,526	1,031	(2,365)	-	17,594	450,514
Buildings	523,702	-	7,654	(3,286)	(20,844)	45,743	552,969
Structures	29,228	-	1,132	(146)	(1,986)	3,309	31,537
Machinery and equipment	390,703	-	9,593	(998)	(60,068)	74,960	414,190
Vehicles and other transportation equipment	3,354	-	771	(16)	(1,569)	79	2,619
Tools	13,329	-	2,350	(11)	(4,188)	448	11,928
Furniture and fixtures	82,448	106	18,699	(297)	(30,037)	2,969	73,888
Other tangible fixed assets	744	-	-	-	-	-	744
Construction-in-progress(*1)	84,053	25,834	106,639	-	-	(137,277)	79,249
	₩ 1,559,289	28,466	147,869	(7,119)	(118,692)	7,825	1,617,638

(*1) Construction-in-progress as of September 30, 2008 includes investment on development of new medicines amounting to ₩25,115 million.

(*2) Other changes for the nine-month period ended September 30, 2008 include the amount transferred to site for building lotting-out construction as part of inventories amounting to ₩3,422 million and the amount transferred from long-term advance payments amounting to ₩1,715 million and change in exchange rate amounting to ₩7,501 million.

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12 Property, Plant and Equipment, Continued

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

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

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

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

13 Officially Declared Value of Land

The officially declared value of land as of September 30, 2008 and December 31, 2007, as announced by the Minister of Construction and Transportation, were as follows:

<i>In millions of Won</i>	September 30, 2008		December 31, 2007	
	Book value	Declared value	Book value	Declared value
Land	₩ 450,514	1,481,751	431,728	1,373,374
Sites for building lotting-out construction	14,519	50,555	13,204	40,356

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 ₩1,319,251 million as of September 30, 2008 with Dongbu Insurance Co., Ltd. and others. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

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15 Pledged Assets

The following assets were pledged as collateral for the Company's short-term borrowings and long-term borrowings as of September 30, 2008:

In millions of Won

<u>Asset</u>	<u>Lender</u>	<u>Type of borrowings</u>	<u>Borrowing amount</u>	<u>Book value</u>	<u>Collateralized amount</u>
Land, Buildings and Structures	Hana Bank	Short-term	₩ 22,200	31,520	60,050
	TongYang Investment Bank Co., Ltd.	Short-term	3,000		
	Woori Investment & Securities Co., Ltd.	Short-term	5,000		
	Hana Bank	Current portion of long-term	280		
	Hana Bank	Long-term	2,545		
			₩ <u>33,025</u>	<u>31,520</u>	<u>60,050</u>

16 Goodwill

Changes in goodwill for the nine-month period ended September 30, 2008 and the year ended December 31, 2007 were as follows:

In millions of Won

	<u>2008</u>	<u>2007</u>
Beginning balance	₩ 4,007	6,977
Amortization	(2,227)	(2,970)
Ending balance	₩ <u>1,780</u>	<u>4,007</u>

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17 Intangible Assets

Changes in intangible assets for the nine-month period ended September 30, 2008 and the year ended December 31, 2007 were as follows:

In millions of Won

		2008		
		Industrial property rights	Other intangible assets	Total
Net balance at beginning of period	₩	2,224	2,428	4,652
			159	159
Increases		259	255	514
Change of Subsidiaries		-		
Amortization and impairment		(646)	(683)	(1,329)
Other		-	8	8
Net balance at end of period	₩	<u>1,837</u>	<u>2,167</u>	<u>4,004</u>

In millions of Won

		2007		
		Industrial property rights	Other intangible assets	Total
Net balance at beginning of period	₩	3,714	1,557	5,271
Increases		425	1,575	2,000
Merger		-	4	4
Amortization and impairment		(1,915)	(708)	(2,623)
Net balance at end of period	₩	<u>2,224</u>	<u>2,428</u>	<u>4,652</u>

18 Other Non-current Assets

Other non-current assets as of September 30, 2008 and December 31, 2007 are summarized as follows:

		September 30, 2008	December 30, 2007
<i>In millions of Won</i>			
Long-term financial instruments (note 4)	₩	8	44
Long-term trade account receivable, net of allowance for doubtful accounts of ₩7,657 in 2008 and ₩7,253 in 2007		109	84
Other investment assets, net of allowance for doubtful accounts of ₩2,912 in 2008 and 2007		1,787	2,578
Long-term other receivables, net of allowance for doubtful accounts of ₩10 in 2008 and 2007		<u>1,017</u>	<u>1,017</u>
	₩	<u>2,921</u>	<u>3,723</u>

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19 Other Current Liabilities

Other current liabilities as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Withholdings	₩ 18,937	11,763
Unearned income	164	89
Withholding guarantee deposits received	95	102
Provision for mileage program	6,976	5,108
Derivatives (note 39)	4,246	25
Current portion of long-term borrowings (notes 15 and 21)	<u>280</u>	<u>210</u>
	₩ <u>30,698</u>	<u>17,297</u>

20 Short-term Borrowings

Short-term borrowings as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>			Amount	
Type of borrowings	Lender	Interest rate per annum	September 30, 2008	December 31, 2007
Credit loans	Hana Bank	7.47~7.90%	₩ 13,000	13,000
Loans for facilities	Hana Bank	7.64%	8,000	8,000
General loan	Hana Bank	6.67%	1,200	1,200
Commercial paper	TongYang Investment Bank Co., Ltd.	7.40%	3,000	-
Commercial paper	SK Securities Co., Ltd.	6.37%	-	5,338
Commercial paper	Woori Investment & Securities Co., Ltd	7.20%	5,000	10,000
Credit loans	Korea Exchange Bank	7.88%	5,000	-
Loans for foreign currency working capital	Standard Chartered First Bank Korea Ltd.	1Y LIBOR +0.80%	-	559
			₩ <u>35,200</u>	<u>38,097</u>

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21 Long-term Borrowings

(a) Long-term borrowings as of September 30, 2008 and December 31, 2007 are summarized as follows:

In millions of Won

<u>Type of borrowings</u>	<u>Lender</u>	<u>Maturity date</u>	<u>Interest rate per annum</u>	<u>Amount</u>	
				<u>September 30, 2008</u>	<u>December 31, 2007</u>
Energy Rationalization Fund	Hana Bank	March 15, 2013	4.25%	₩ 1,261	1,402
Environmental Management Corporation Fund	Hana Bank	March 31, 2017	5.35%	1,563	1,541
				2,824	2,943
Less current portion				(280)	(210)
				₩ 2,544	2,733

(b) Repayment schedule for the Company's long-term borrowings as of September 30, 2008 is as follows:

In millions of Won

<u>Period ending September 30,</u>	<u>Amount</u>
2009	₩ 280
2010	392
2011	504
2012	504
thereafter	1,144
	₩ 2,824

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22 Retirement and Severance Benefits

Changes in the retirement and severance benefits for the nine-month period ended September 30, 2008 and the year ended December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	<u>September 30, 2008</u>	<u>December 31, 2007</u>
Estimated retirement and severance benefits at beginning of period	₩ 219,494	208,923
Provision for retirement and severance benefits	47,918	40,335
Reversal of retirement and severance benefits	-	-
Unearned Stock Compensation	(4,941)	-
Payments (*)	<u>(11,231)</u>	<u>(29,764)</u>
Estimated retirement and severance benefits at end of period	251,240	219,494
Contribution to the National Pension Fund	(274)	(295)
Deposit for severance benefits trust	<u>(134,255)</u>	<u>(132,807)</u>
Net balance at end of period	₩ <u>116,711</u>	<u>86,392</u>

- (*) Compensations paid with treasury stock amounting to ₩2,430 million and ₩8,247 million for the nine-month period ended September 30, 2008 and the year ended December 31, 2007 were included.

The Company maintains employees' severance benefit trust arrangements with Samsung Life Insurance Co., Ltd. and others. Under these arrangements, the Company has made a deposit in the aggregate amount equal to 53.4% and 60.5% of the reserve balances of retirement and severance benefits as of September 30, 2008 and December 31, 2007, respectively. This deposit is to be used to make the required payments to the retirees and accounted for as a reduction of the reserve balance.

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23 Assets and Liabilities Denominated in Foreign Currencies

Details of assets and liabilities denominated in foreign currencies as of September 30, 2008 and December 31, 2007 were as follows:

In millions of Won

In thousands of US dollars, JPY, Euro, GBP and NTD

		Foreign currency		Won equivalent	
		September 30, 2008	December 31, 2007	September 30, 2008	December 31, 2007
Assets:					
Cash and cash equivalents	USD	3,217	9,984	₩ 3,821	9,367
	JPY	6,663	34,467	76	287
	NTD	6,567	1,495	246	43
Trade accounts receivable	USD	229,505	166,988	244,203	156,668
	EUR	1,083	816	1,849	1,127
	JPY	609	250,854	280	2,090
	NTD	2,411	-	90	-
Other receivables	USD	259	259	307	243
Long-term deposits in the Escrow Fund	USD	84,519	71,022	100,384	66,633
Total	USD	317,500	248,253	₩ 348,715	232,911
	EUR	1,083	816	1,849	1,127
	JPY	7,272	285,321	356	2,377
	NTD	8,978	1,495	336	43
Liabilities:					
Trade accounts payable	USD	3,453	1,351	₩ 4,102	1,267
	EUR	3,849	2,535	6,570	3,502
	JPY	23,846	2,613	273	22
Other payables	GBP	225	-	481	-
Total	USD	3,453	1,351	₩ 4,102	1,267
	EUR	3,849	2,535	6,570	3,502
	JPY	23,846	2,613	273	22
	GBP	225	-	481	-

24 Commitments and Contingencies

Under the Escrow Statute imposed by those states in the United States of America, where the Company's tobacco products have been sold, the Company is required to make deposits equal to certain percentage of its sales to the Escrow Funds of those state governments. The deposits will be included in the state governments' medical budgets to compensate for any medical costs incurred by those tobacco consumers. Any deposit amounts remaining in the Escrow Funds, unused after 25 years from the dates of the deposits will be refunded to the Company. As of September 30, 2008 and December 31, 2007, the Company made deposits of ₩100,384 million and ₩66,633 million, respectively which were recorded long-term deposits in Escrow Funds in the accompanying consolidated balance sheets.

As of September 30, 2008, four tobacco lawsuits claiming damages of ₩759 million were filed against the Company and the Korean government. The Company is also involved in 15 other lawsuits and claims for alleged damages. As the ultimate outcome of those lawsuits and claims cannot be reasonably estimated as of September 30, 2008, the amount of liabilities has not been estimated.

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24 Commitments and Contingencies, Continued

As of September 30, 2008, the Company has provided the National Agricultural Cooperative Federation ("NACF") and other banks, with guarantees in the aggregate amount of ₩11,993 million for the customers who made a financing agreement with the financial institutions.

As of September 30, 2008, the Company has entered into Letter of Credit agreements with NACF and several financial institutions in the amount of USD 128,500 thousand.

As of September 30, 2008, the Company has an export guaranty insurance coverage of USD 34,900 thousand with the Korea Export Insurance Corporation in connection with its tobacco exports.

As of September 30, 2008, the Company has been provided with a foreign currency payment guarantee for local dealers for the Company's tobacco products in Russia and other countries. The guarantee provided by Korea Exchange Bank and others is for payments of duty and other tax imposed on the dealers covering up to USD 90,000 thousand,

The Company entered into an overdraft agreement with a limit of ₩10,000 million with the NACF as of September 30, 2008.

The Company and 28 other companies were provided with payment guarantees of ₩240,000 million by Seoul Guarantee Insurance Co.,Ltd. in relation to Yongsan International Commercial Development Project.

The Company maintains a contract with the farmers who grow nine-year old green ginseng for purchase volume guarantees. As of September 30, 2008, advance payments to the farmers in accordance with the contract amounted to ₩178,998 million.

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

As of September 30, 2008, the Company has entered into note discounting contracts with Hana Bank and others with the aggregate of lines of credit of ₩19,000 million, and the amount discounted but not due as of September 30, 2008 totaled ₩6,697 million.

As of September 30, 2008, the Company provided 2 blank notes and 16 notes amounting to ₩27,200 million notes and 5 blank checks to Woori Investment & Securities Co.,Ltd. and others as collateral for its short-term and long-term borrowings and trade agreements.

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25 Capital Adjustments

Capital adjustments as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Treasury stock	₩ (311,692)	(414,947)
Unearned stock compensation	4,941	-
	<u>(306,751)</u>	<u>(414,947)</u>

26 Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Unrealized gain on valuation of available-for-sale securities	₩ 45,536	2,100
Unrealized gain on valuation of equity method investment securities	132	1,035
Gain (Loss) on overseas operations translation	6,876	(639)
	<u>₩ 52,544</u>	<u>2,496</u>

27 Retained Earnings

Retained earnings as of September 30, 2008 and December 31, 2007 are summarized as follows:

<i>In millions of Won</i>	September 30, 2008	December 31, 2007
Legal reserve	₩ 602,937	602,937
Reserve for business expansion	698,881	698,881
Reserve for business rationalization	12,851	12,851
Reserve for research and human resource development	30,000	45,000
Reserve for loss on reissuance of treasury stock	26,646	26,646
Other appropriations	420,000	350,000
Unappropriated retained earnings at end of period	<u>442,391</u>	<u>398,421</u>
	<u>₩ 2,233,706</u>	<u>2,134,736</u>

(a) Legal Reserve

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

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27 Retained Earnings, Continued

(b) Reserve for Business Expansion

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

(c) Reserve for Business Rationalization

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

(d) Reserve for Business Rationalization, Continued

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

(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 period of restoration. Reserves without specific purposes are restored to retained earnings by a resolution at a general meeting of stockholders.

28 Building Lotting-out Construction Contracts

(a) Lotting-out contracts of building construction as of September 30, 2008 are summarized as follows:

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

(b) Details of installment sales as of September 30, 2008 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 2008</u>	<u>Nine-month period ended September 30, 2008</u>	
<i>In millions of Won</i>					
Apartment buildings in Jeonju	₩ 284,995	80,927	20,275	32,989	231,731
Apartment buildings in Daejeon	<u>44,047</u>	<u>20,719</u>	-	<u>4,111</u>	<u>39,936</u>
	<u>₩ 329,042</u>	<u>101,646</u>	<u>20,275</u>	<u>37,100</u>	<u>271,667</u>

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28 Building Lotting-out Construction Contracts, Continued

(c) Cost of installment sales of housing units as of September 30, 2008 are summarized as follows:

<i>In millions of Won</i>		Prior to 2008	Nine-month period ended September 30, 2008	Aggregate amount
Apartment buildings in Jeonju	₩	13,726	22,370	36,096
Apartment buildings in Daejeon		-	2,841	2,841
	₩	13,726	25,211	38,937

29 Selling, General and Administrative Expenses

The details of selling, general and administrative expenses for the three- and nine-month periods ended September 30, 2008 and 2007 were as follows:

<i>In millions of Won</i>		2008		2007	
		Three months	Nine months	Three months	Nine months
Salaries	₩	60,966	171,787	51,263	157,702
Provision for severance benefits		12,275	31,585	7,491	19,727
Welfare		4,326	17,889	6,435	19,841
Travel		2,048	6,984	2,221	6,252
Communications		1,235	3,790	1,151	3,525
Utilities		1,510	4,660	1,494	4,438
Taxes and dues		10,046	18,509	7,006	15,637
Supplies		1,719	3,724	632	2,077
Uniforms		80	140	40	81
Rent		3,091	9,052	2,338	6,237
Depreciation		13,947	42,489	14,119	42,194
Amortization		1,169	3,539	1,128	3,358
Repairs and maintenance		2,283	4,814	1,335	3,823
Vehicles		2,636	7,003	1,983	5,600
Insurance		336	1,044	267	926
Commissions		21,804	63,841	20,200	60,731
Transportation and warehousing		8,939	22,946	7,553	23,160
Entertainment		208	1,317	402	1,275
Conferences		1,458	4,157	1,376	4,506
Advertising		49,468	133,906	43,045	118,458
Training		2,724	6,493	2,305	7,004
Prizes and rewards		465	4,660	341	1,410
Cooperation		137	824	156	543
Normal research and development		5,122	14,128	5,229	15,496
Sample		9	21	4	7
Bad debts		6,875	12,977	-	4,027
Other		287	1,003	322	1,188
	₩	215,163	593,282	179,836	529,223

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30 Added Value

The components of manufacturing costs and selling, general and administrative expenses which are necessary in calculating added value for the three- and nine-month periods ended September 30, 2008 and 2007 were as follows:

<i>In millions of Won</i>	2008		2007	
	Three months	Nine months	Three months	Nine months
Wages and salaries	₩ 104,085	292,367	89,255	274,464
Provision for severance benefits	22,085	47,918	12,530	29,017
Employee welfare	11,460	35,522	10,158	30,565
Rent	7,274	17,216	4,506	12,426
Depreciation	39,106	118,692	38,322	111,442
Taxes and dues	11,529	21,663	8,254	18,449

31 Employee Welfare and Contributions to Society

For employee welfare, the Company maintains a refectory, infirmary, athletic facilities, scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spent for the nine-month periods ended September 30, 2008 and 2007 were estimated at ₩35,522 million and ₩30,565 million, respectively.

The Company donated ₩26,468 million and ₩15,523 million to KT&G Social Welfare Foundation and others for the nine-month periods ended September 30, 2008 and 2007, respectively.

32 Income Taxes

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

Taxable income	Tax rate
Up to ₩100 million	14.3%
Over ₩100 million	27.5%

(b) The components of income tax expense for the three- and nine-month periods ended September 30, 2008 and 2007 are summarized as follows:

<i>In millions of Won</i>	2008		2007	
	Three months	Nine months	Three months	Nine months
Current income tax expense	₩ 82,431	246,878	119,299	262,294
Deferred income tax expense	29,978	38,764	(1,112)	6,777
Income tax expense charged directly to stockholders' equity	(16,396)	(18,549)	(37,565)	(40,684)
Income tax expense	₩ 96,013	267,093	80,622	228,387

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32 Income Taxes, Continued

- (c) The income tax expense calculated by applying the statutory tax rates differs from the actual income tax expense for the three- and nine-month periods ended September 30, 2008 and 2007 for the following reasons:

<i>In millions of Won</i>	2008		2007	
	Three months	Nine months	Three months	Nine months
Tax at the applicable statutory tax rate	₩ 100,215	284,084	86,704	235,767
Adjustments:				
Non-taxable income	508	(15,906)	(65)	(5,433)
Non-deductible expense	1,690	4,149	1,034	2,457
Tax credit	(1,644)	(5,004)	(1,209)	(3,884)
Changes in valuation allowances for deferred income tax assets (liabilities) arisen from equity in income of affiliates	(4,791)	918	(4,718)	610
Additional income taxes for prior period (Refund of prior year's income taxes)	-	(1,120)	828	930
Other	35	(28)	(1,952)	(2,060)
Income tax expense	₩ 96,013	267,093	80,622	228,387

- (d) The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 29.16% and 30.85% for the nine-month periods ended September 30, 2008 and 2007.
- (e) The Company did not recognize a deferred tax liability in the amount of ₩53,408 million and ₩58,200 million arising from the taxable temporary differences associated with affiliates as of September 30, 2008 and December 31, 2007, respectively, since non-taxable dividend income is excluded from equity in income of affiliates in the calculation of deferred tax liabilities. Also the Company did not recognize a deferred tax liability in the amount of ₩6,914 million and ₩3,450 million arising from the taxable temporary differences as of September 30, 2008 and December 31, 2007, respectively.
- (f) The Company did not recognize a deferred tax asset in the amount of ₩30,805 million and ₩31,749 million arising from the deductible temporary differences associated with affiliates as of September 30, 2008 and December 31, 2007, respectively, since there is a remote possibility that the Company will dispose of its investments in affiliates in the foreseeable future. In addition, the Company did not recognize a deferred tax asset in the amount of ₩53,632 million and ₩56,112 million arising from other deductible temporary differences as of September 30, 2008 and December 31, 2007, respectively.
- (g) Deferred tax assets and liabilities that were directly charged or credited to accumulated other comprehensive income for the nine-month periods ended September 30, 2008 and 2007 were as follows:

<i>In millions of Won</i>	2008	2007
Gain on reissuance of treasury stock	₩ 1,659	37,728
Unrealized gain on valuation of available-for-sale securities	16,476	2,975
Unrealized loss on valuation of equity method investments	-	(2)
Losses on overseas operations translation	414	(17)
	₩ 18,549	40,684

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32 Income Taxes, Continued

- (h) Under SKAS No. 16, *Income Taxes*, the deferred tax amounts should be presented as a net current asset or liability and a net non-current asset or liability. In addition, the Company is required to disclose aggregate deferred tax assets (liabilities). As of September 30, 2008, details of aggregate deferred tax assets (liabilities) were as follows:

<i>In millions of Won</i>	Temporary differences at September 30, 2008	Deferred tax assets (liabilities)	
		Current	Non-current
Assets:			
Provision for retirement and severance benefits	₩ 176,572	-	44,380
Loss on valuation of inventories	12,418	212	-
Depreciation	17,385	-	4,172
Bad debt	40,808	6,168	-
Impairment losses on property, plant and equipment	4,719	-	697
Impairment losses on available-for-sale security	8,089	-	2,097
Impairment losses on intangible assets	2,266	-	451
Accrued expense	23,238	6,390	-
Donation in excess of tax limit	42,617	4,500	7,221
	<u>328,112</u>	<u>17,270</u>	<u>59,018</u>
Liabilities:			
Deposit for severance benefits trust	(134,240)	-	(36,169)
Reserve for research and human resource development	(29,973)	-	(8,242)
Equity method investment securities	(507,987)	-	(133,010)
Reserve for losses on reissuance of treasury stock	(26,646)	-	(7,328)
Available-for-sale securities	(62,810)	-	(17,273)
Treasury stock	(38,930)	-	(10,706)
Other	(26,885)	(8,438)	948
	<u>(499,359)</u>	<u>8,832</u>	<u>(152,762)</u>
Unused tax losses	23,207	-	-
Net differed tax asset(liability)	<u>₩ (476,152)</u>	<u>8,832</u>	<u>(152,762)</u>

- (*) The carry forward of unused tax losses in respect of which deferred tax assets in the amount of ₩23,207 million and unused tax credit in the amount of ₩3,231 million have not been recognized as of September 30, 2008 due to the remote likelihood of utilization.

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33 Earnings Per Share

(a) Basic earnings per share

Basic earnings per share for the nine-month periods ended September 30, 2008 and 2007 were computed as follows:

<i>In millions of Won except share information</i>	<u>2008</u>	<u>2007</u>
Controlling interest in net income per accompanying consolidated statements of income	₩ 649,186	526,755
Weighted-average number of shares outstanding	<u>130,558,756</u>	<u>132,594,933</u>
Basic earnings per share in Korean Won	₩ <u>4,972</u>	<u>3,973</u>

Basic earnings per share for the three-month periods ended September 30, 2008 and 2007 were computed as follows:

<i>In millions of Won except share information</i>	<u>2008</u>	<u>2007</u>
Controlling interest in net income per accompanying consolidated statements of income	₩ 230,613	198,725
Weighted-average number of shares outstanding	<u>130,470,228</u>	<u>132,306,331</u>
Basic earnings per share in Korean Won	₩ <u>1,768</u>	<u>1,502</u>

(b) Potential dilutive securities which are not included in the calculation of diluted earnings per share for the nine-month period ended September 30, 2008 are summarized as follows:

<u>Type</u>	<u>Par value in Korean Won</u>	<u>Maturity date</u>	<u>Issuable number of shares</u>
Retirement and severance benefits (share-based payment)	₩ 5,000	February 28 , 2009 ~ March 31, 2010	107,663

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34 Share-based Payment

(a) The details of the Company's stock compensation plan as of September 30, 2008 was as follows:

	<u>KT&G</u>	<u>Yungjin Pharm. Ind. Co., Ltd.</u>
Type	Performance-based severance pay by share grant(*)	Stock option
Grant date	March 1, 2007~ April 1, 2008	March 27, 2001
Number of shares granted	107,663	400,000
Conditions	Service condition: 1~3 periods Non-market performance condition: long-term evaluation results based on quantified and non-quantified indices	Service condition: 3 periods Exercisable period: 2004.3.27 ~ 2009.3.26 Exercise price : ₩3,200

(*) Employees who have been with the Company for more than one period are entitled to performance-based severance payment. Eligible employees have the option to choose the Company's shares for their severance pay. The number of shares that may be granted is subject to the level of performance and service period.

(b) Share-based payment expense for the nine-month period ended September 30, 2008 is summarized as follows:

<i>In millions of Won</i>	<u>Amount</u>	
Share-based payment expense (recognized) (retirement and severance payment)	₩	10,729
Remaining expense to be recognized in the future years		4,051

35 Comprehensive Income

Comprehensive income for the nine-month periods ended September 30, 2008 and 2007 was as follows:

<i>In millions of Won</i>	<u>2008</u>	<u>2007</u>
Net income	₩ 649,002	511,945
Change in fair value of available-for-sale securities, net of tax effect of ₩16,476 in 2008 and ₩2,975 in 2007	43,436	7,841
Increase in unrealized gain on valuation of equity method investments, net of tax effect of ₩0 in 2008 and ₩(2) in 2007	-	(622)
Change in translation adjustments, net of tax effect of ₩414 in 2008 and ₩(17) in 2007	7,515	803
Other	(903)	-
Comprehensive income	₩ <u>699,050</u>	<u>519,967</u>
Controlling company's interest	₩ 699,234	534,855
Minority interest	(184)	(14,888)

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36 Segment Information

- (a) The Company has three reportable operating segments - manufacturing and selling tobacco (the tobacco segment), manufacturing and selling ginseng products (the ginseng segment), and other operations.
- (b) Information on each operating segment as of and for the nine-month period ended September 30, 2008 was as follows:

<i>In millions of Won</i>	Tobacco	Ginseng	Other operations	Consolidation adjustment	Total
Sales	₩ 1,895,200	482,881	117,105	(42,117)	2,453,069
Operating income	697,897	160,733	1,247	(2,124)	857,752
Total assets	4,322,852	699,373	107,361	(725,237)	4,404,349

- (c) Information on each operating segment as of and for the nine-month period ended September 30, 2007 was as follows:

<i>In millions of Won</i>	Tobacco	Ginseng	Other operations	Consolidation adjustment	Total
Sales	₩ 1,796,184	401,668	93,575	(24,047)	2,267,380
Operating income (loss)	629,150	127,659	(5,658)	9,532	760,683
Total assets	4,499,371	623,341	113,137	(563,395)	4,672,454

37 Non-cash Investing and Financing Activities

Significant non-cash investing and financing activities for the nine-month periods ended September 30, 2008 and 2007 are summarized as follows:

<i>In millions of Won</i>	2008	2007
Retirement of treasury stock	₩ 209,767	269,410
Compensation by treasury stock	5,982	2,999
Severance pay by treasury stock	2,430	6,336

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38 Consolidated Net Income and Net Income in Minority Interest

Consolidated net income and net income in minority interest for the nine-month period ended September 30, 2008 was as follows:

*In millions of Won,
except percentage
of ownership*

Company	Adjusted net income			Minority interest in net income		Controlling interest in net income		
	Non-consolidated net income (loss)	Adjustments (*)	Adjusted net income (loss)	Equity ownership of minority interest(%)	Net income in minority interest	Net income (loss) before goodwill amortization	Goodwill amortization	Controlling interest in net income
KT&G	₩ 648,941	(111,249)	537,692	0.00%	-	537,692	(2,227)	535,465
KGC	116,392	(312)	116,080	0.00%	-	116,080	-	116,080
KGHK	528	-	528	0.00%	-	528	-	528
TAI	685	(98)	587	0.00%	-	587	-	587
YJPI	(445)	32	(413)	44.50%	(184)	(229)	-	(229)
KTMST	(3,245)	-	(3,245)	0.01%	-	(3,245)	-	(3,245)
	₩ <u>762,856</u>	<u>(111,627)</u>	<u>651,229</u>		<u>(184)</u>	<u>651,413</u>	<u>(2,227)</u>	<u>649,186</u>

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

KT&G CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

September 30, 2008 and 2007

39 Derivative Instruments

- (a) The Company entered into foreign currency forward and foreign currency option contracts to hedge foreign currency risk of accounts receivable. Details of the contracts as of September 30, 2008 were as follows:

In Won and thousands of US dollars

Derivative Instrument	Contractor	Contract position	Exchange rate	Contract date	Expiration date	Contract amount
Currency option	Korea Exchange Bank	Call Option	₩ 988	March 11, 2008	October 29, 2008~	USD 12,000
		Sell			March 27, 2009	USD 6,000
	Citibank, N.A., Seoul	Put Option	₩ 989	March 12, 2008	October 29, 2008~	USD 10,000
		Buy			February 25, 2009	USD 5,000

- (b) Details of gain and loss on valuation of derivative instruments for the nine-month periods ended September 30, 2008 and 2007 are as follows:

In millions of Won

	2008	2007
Currency forward	₩ -	69
Currency option	(4,246)	-
	₩ (4,246)	69