

KT&G CORPORATION

Non-Consolidated Financial Statements

(Unaudited)

June 30, 2007 and 2006

(With Independent Accountants' Review Report Thereon)

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

We conducted our reviews in accordance with the Review Standards for Semiannual Financial Statements established by the Securities and Futures Commission of the Republic of Korea. These standards require that we plan and perform the review to obtain moderate assurance as to whether the 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 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 non-consolidated balance sheet of the Company as of December 31, 2006, and the related non-consolidated statements of income, appropriation of retained earnings and cash flows for the year then ended, which are not accompanying this report, were audited by us and our report thereon, dated January 13, 2007, expressed an unqualified opinion on those statements. The accompanying non-consolidated balance sheet of the Company as of December 31, 2006, presented for comparative purposes, is not different from that audited by us in all material respects.

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

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

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

As discussed in note 19 to the non-consolidated financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩1,282 million caused by smoking. The final outcome of these lawsuits cannot be estimated. Accordingly, no provisions have been made in the accompanying non-consolidated financial statements.

As discussed in note 19 to the non-consolidated financial statements, the Company has entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund with the target set at ₩410,000 million by 2008 for the purpose of stabilizing tobacco production. Under the agreement, the Company is obligated to make up the deficiency, should the fund fall short of the target. The Company estimates the deficiency at the end of each period and provides for a provision to fully fund the tobacco production stabilization program by 2008. The provision for the fund made by the Company amounted to ₩8,935 million and ₩9,041 million for the six-month periods ended June 30, 2007 and 2006, respectively, and the reserve for the fund as of June 30, 2007 and December 31, 2006 amounted to ₩83,419 million and ₩74,484 million, respectively.

Seoul, Korea
July 10, 2007

This report is effective as of July 10, 2007, the review report date. Certain subsequent events or circumstances, which may occur between the review report date and the time of reading this report, could have a material impact on the accompanying financial non-consolidated statements and notes thereto. Accordingly, the readers of the review report should understand that there is a possibility that the above review report may have to be revised to reflect the impact of such subsequent events or circumstances, if any.

KT&G CORPORATION

Non-Consolidated Balance Sheets

June 30, 2007 and December 31, 2006

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

Assets	2007 (Unaudited)		2006 (Audited)
	Korean Won	U.S. dollars (note 2)	Korean Won
Current assets:			
Cash and cash equivalents (note 15)	₩ 294,033	\$ 317,256	₩ 165,924
Short-term financial instruments	1,000	1,079	1,000
Trade accounts receivable, net of allowance for doubtful accounts of ₩2,670 in 2007 and ₩2,659 in 2006 (notes 7 and 15)	269,350	290,623	263,164
Inventories (notes 3 and 11)	897,168	968,028	1,016,540
Current portion of long-term loans, net of allowance for doubtful accounts of ₩1,064 in 2007 and ₩1,000 in 2006 and present value discount of ₩4,976 in 2007 and ₩11,416 in 2006 (note 8)	105,360	113,681	98,984
Current portion of deferred income tax assets (note 22)	7,788	8,404	7,760
Other current assets (note 4)	<u>108,322</u>	<u>116,876</u>	<u>49,377</u>
Total current assets	1,683,020	1,815,947	1,602,749
Available-for-sale securities (note 5)	292,371	315,463	69,779
Equity method investment securities (note 6)	518,205	559,134	490,885
Long-term loans to employees	66,665	71,930	61,106
Guarantee deposits paid	28,466	30,714	29,579
Guarantee deposits for membership	20,499	22,118	20,499
Long-term deposits in Escrow Fund (notes 15 and 19)	59,744	64,463	45,611
Other investments assets	558	602	395
Property, plant and equipment, at cost (notes 9,10 and 11)	2,108,421	2,274,948	2,040,832
Less accumulated depreciation and impairment loss	<u>(754,016)</u>	<u>(813,569)</u>	<u>(696,676)</u>
Net property, plant and equipment	1,354,405	1,461,379	1,344,156
Intangible assets	1,946	2,099	2,106
Other assets (note 12)	<u>1,997</u>	<u>2,154</u>	<u>1,514</u>
Total assets	₩ <u>4,027,876</u>	\$ <u>4,346,003</u>	₩ <u>3,668,381</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Balance Sheets, Continued

June 30, 2007 and December 31, 2006

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

<u>Liabilities and Stockholders' Equity</u>	<u>2007 (Unaudited)</u>		<u>2006 (Audited)</u>
	<u>Korean Won</u>	<u>U.S. dollars (note 2)</u>	<u>Korean Won</u>
Current liabilities:			
Trade accounts payable (notes 7 and 15)	₩ 23,100	\$ 24,924	₩ 9,176
Value added tax payable	138,004	148,904	128,878
Accrued expenses	12,922	13,942	6,845
Other payables	24,321	26,242	17,873
Tobacco excise tax and other	612,380	660,747	55,388
Income taxes payable	114,997	124,080	112,288
Other current liabilities (note 13)	<u>14,817</u>	<u>15,987</u>	<u>15,399</u>
Total current liabilities	940,541	1,014,826	345,847
Retirement and severance benefits (note 14)	77,313	83,419	77,697
Guarantee deposits received (note 7)	25,808	27,847	29,783
Deferred income tax liabilities (note 22)	104,630	112,894	94,798
Reserve for Tobacco Production Stabilization Fund (note 20)	<u>83,419</u>	<u>90,008</u>	<u>74,484</u>
Total liabilities	<u>1,231,711</u>	<u>1,328,993</u>	<u>622,609</u>
Stockholders' equity :			
Common stock of ₩5,000 par value (notes 1):			
Authorized – 800,000,000 shares			
Issued – 143,442,497 shares			
Outstanding 129,371,548 shares in 2007 and 133,213,315 shares in 2006	954,959	1,030,384	954,959
Capital surplus	340,020	366,875	335,414
Capital adjustments (note 16)	(318,573)	(343,735)	(321,904)
Accumulated other comprehensive income (notes 5 and 17)	19,631	21,182	15,784
Retained earnings (note 18)	<u>1,800,128</u>	<u>1,942,304</u>	<u>2,061,519</u>
Total stockholders' equity	2,796,165	3,017,010	3,045,772
Commitments and contingencies (note 19)			
Total liabilities and stockholders' equity	₩ <u>4,027,876</u>	\$ <u>4,346,003</u>	₩ <u>3,668,381</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Income

For the six-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Sales:			
Tobacco sales	₩ 1,131,535	\$ 1,220,905	₩ 993,942
Lotting-out (note 21)	5,984	6,457	26,385
Other	<u>23,552</u>	<u>25,412</u>	<u>22,295</u>
	1,161,071	1,252,774	1,042,622
Cost of sales (notes 21,25 and 26)	<u>487,865</u>	<u>526,397</u>	<u>472,423</u>
Gross profit	673,206	726,377	570,199
Selling, general and administrative expenses (notes 25,26 and 27)	<u>277,646</u>	<u>299,575</u>	<u>254,295</u>
Operating income	<u>395,560</u>	<u>426,802</u>	<u>315,904</u>
Other income (expense):			
Interest income	18,324	19,771	20,225
Interest expense	(17)	(18)	(70)
Other bad debts expense	(64)	(69)	-
Loss on foreign currency transactions, net	(745)	(804)	(4,764)
Donations (note 26)	(6,805)	(7,342)	(41,212)
Contribution to Tobacco Production Stabilization Fund (note 20)	(8,935)	(9,642)	(9,041)
Loss on impairment of available-for-sale securities	(2,150)	(2,320)	(2,363)
Gain on valuation of equity method investments (note 6)	65,781	70,976	50,316
Loss on valuation of equity method investments (note 6)	(17,421)	(18,797)	(2,981)
Gain on sale of equity method investments	-	-	17,428
Gain on sale of property, plant and equipment, net	4,932	5,322	1,501
Gain on conversion of convertible bonds	-	-	1,875
Other, net	<u>1,881</u>	<u>2,031</u>	<u>3,782</u>
	<u>54,781</u>	<u>59,108</u>	<u>34,696</u>
Income before income taxes	450,341	485,910	350,600
Income taxes (note 22)	<u>122,611</u>	<u>132,295</u>	<u>98,012</u>
Net income	₩ <u>327,730</u>	\$ <u>353,615</u>	₩ <u>252,588</u>
Basic earnings per share in Korean Won and U.S. dollars (note 23)	₩ <u>2,469</u>	\$ <u>2,664</u>	₩ <u>1,746</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Income, Continued

For the three-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Sales:			
Tobacco sales	₩ 627,784	\$ 677,367	₩ 574,017
Lotting-out (note 21)	5,921	6,389	15,668
Other	<u>11,896</u>	<u>12,836</u>	<u>12,345</u>
	645,601	696,591	602,030
Cost of sales (notes 21 and 25)	<u>261,850</u>	<u>282,531</u>	<u>266,865</u>
Gross profit	383,751	414,060	335,165
Selling, general and administrative expenses (notes 25 and 27)	<u>144,822</u>	<u>156,260</u>	<u>134,504</u>
Operating income	<u>238,929</u>	<u>257,800</u>	<u>200,661</u>
Other income (expense):			
Interest income	8,489	9,159	10,529
Interest expense	9	10	(37)
Other bad debts expense	33	36	(378)
Loss on foreign currency transactions, net	(1,840)	(1,985)	(1,089)
Donations	(412)	(445)	(28,791)
Contribution to Tobacco Production Stabilization Fund (note 20)	(4,634)	(5,000)	(4,521)
Loss on impairment of available-for-sale securities	(2,150)	(2,320)	(763)
Gain on valuation of equity method investments (note 6)	37,317	40,264	27,160
Loss on valuation of equity method investments (note 6)	(16,241)	(17,524)	(1,540)
Gain on sale of equity method investments	-	-	17,428
Gain on sale of property, plant and equipment, net	1,424	1,536	2,070
Other, net	<u>4,403</u>	<u>4,751</u>	<u>1,254</u>
	<u>26,397</u>	<u>28,482</u>	<u>21,322</u>
Income before income taxes	265,326	286,282	221,983
Income taxes (note 22)	<u>67,780</u>	<u>73,133</u>	<u>65,912</u>
Net income	<u>₩ 197,546</u>	<u>\$ 213,149</u>	<u>₩ 156,071</u>
Basic earnings per share			
in Korean Won and U.S. dollars (note 23)	<u>₩ 1,494</u>	<u>\$ 1,612</u>	<u>₩ 1,083</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Cash Flows

For the six-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from operating activities:			
Net income	₩ 327,730	\$ 353,615	₩ 252,588
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	67,314	72,631	58,723
Loss on valuation of inventories, net	1,617	1,745	14,075
Bad debts expense	11	12	110
Loss on impairment of available-for-sale securities	2,150	2,320	2,363
Gain on valuation of equity method investments, net	(48,359)	(52,178)	(47,335)
Dividend from equity method investments	-	-	(17,428)
Gain on dividend of equity method investments	20,000	21,580	-
Loss on foreign currency transactions, net	503	543	622
Other bad debts expense	64	69	-
Provision for retirement and severance benefits	12,960	13,984	11,634
Gain on sale of property, plant and equipment, net	(4,932)	(5,322)	(1,501)
Amortization of present value discounts	(6,440)	(6,949)	(5,753)
Reversal of bad debts	(85)	(92)	-
Provision for Tobacco Production Stabilization Fund	8,936	9,642	9,042
Gain on conversion of convertible bonds	-	-	(1,875)
Deferred income taxes	8,344	9,003	5,641
Payments of retirement and severance benefits	(8,244)	(8,895)	(2,587)
Decrease (increase) in deposit for severance benefits trust	1,236	1,334	(510)
Decrease (increase) in assets:			
Trade accounts receivable	(6,438)	(6,946)	(15,773)
Other receivables	(3,399)	(3,667)	(2,316)
Accrued income	(1,306)	(1,409)	2,750
Advance payments	(48,368)	(52,188)	(34,173)
Prepaid expenses	(9,131)	(9,852)	(6,929)
Inventories	117,754	127,054	145,132
Increase (decrease) in liabilities:			
Trade accounts payable	13,956	15,058	6,158
Other payables	6,448	6,957	8,214
Advance receipts	2,911	3,141	968
Withholdings	(2,295)	(3,156)	(13,590)
Value added tax withholdings	9,127	9,848	2,410
Accrued expenses	9,076	9,793	3,203
Tobacco excise taxes and dues payable	556,993	600,985	213,018
Income taxes payable	962	1,038	25,932
Other, net	57	62	641
Net cash provided by operating activities	<u>1,028,520</u>	<u>1,109,754</u>	<u>613,454</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Cash Flows, Continued

For the six-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from investing activities (note 24):			
Decrease in short-term financial instruments	₩ -	\$ -	₩ 170,000
Proceeds from sale of available-for-sale securities	1,289	1,391	5,180
Proceeds from sale of equity method investment securities	-	-	40,148
Decrease in long-term loans to employees, net	(4,289)	(4,628)	13,069
Proceeds from sale of property, plant & equipment	13,916	15,015	4,387
Purchases of available-for-sale securities	(219,644)	(236,992)	(4,730)
Increase in long-term deposit in escrow fund	(14,402)	(15,539)	(12,055)
Purchases of property, plant & equipment	(86,183)	(92,990)	(84,766)
Purchases of intangible assets	(204)	(220)	(105)
Other, net	2,203	2,376	(419)
Net cash provided by (used in) investing activities	<u>(307,314)</u>	<u>(331,587)</u>	<u>130,709</u>
Cash flows from financing activities (note 24):			
Increase (decrease) in guarantee deposits received	(3,975)	(4,289)	2,566
Reissuance of treasury stock	-	-	22,763
Reacquisition of treasury stock	(269,410)	(290,689)	(160,819)
Payment of dividends	<u>(319,712)</u>	<u>(344,963)</u>	<u>(249,702)</u>
Net cash used in financing activities	<u>(593,097)</u>	<u>(639,941)</u>	<u>(385,192)</u>
Net increase in cash and cash equivalents	128,109	138,226	358,971
Cash and cash equivalents at beginning of period	<u>165,924</u>	<u>179,029</u>	<u>333,107</u>
Cash and cash equivalents at end of period	₩ <u>294,033</u>	\$ <u>317,256</u>	₩ <u>692,078</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Cash Flows, Continued

For the three-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006	
	Korean Won	U.S. dollars (note 2)	Korean Won	
Cash flows from operating activities:				
Net income	₩ 197,546	\$ 213,149	₩ 156,071	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	33,700	36,362	29,655	
Loss (gain) on valuation of inventories, net	(7,088)	(7,648)	4,923	
Bad debts expense	11	12	-	
Loss on impairment of available-for-sale securities	2,150	2,320	763	
Gain on valuation of equity method investments, net	(21,076)	(22,741)	(25,620)	
Gain on sale of equity method investments	-	-	(17,428)	
Dividend from equity method investments	20,000	21,580	-	
Gain on foreign currency transactions, net	1,073	1,158	(758)	
Other bad debts expense	265	286	378	
Provision for retirement and severance benefits	10,906	11,767	8,191	
Gain on sale of property, plant and equipment, net	(1,424)	(1,536)	(2,070)	
Amortization of present value discounts	(3,282)	(3,541)	(2,938)	
Reversal of bad debts	(411)	(443)	(132)	
Provision for Tobacco Production Stabilization Fund	4,634	5,000	4,521	
Deferred income taxes	(1,857)	(2,004)	5,607	
Payments of retirement and severance benefits	(2,792)	(3,013)	(1,877)	
Decrease in deposit for severance benefits trust	239	258	136	
Decrease (increase) in assets:				
Trade accounts receivable	(41,026)	(44,266)	(46,143)	
Other receivables	13,019	14,047	2,135	
Accrued income	1,227	1,324	1,632	
Advance payments	(49,846)	(53,783)	(29,304)	
Prepaid expenses	18,658	20,132	15,905	
Inventories	68,578	73,994	97,851	
Increase (decrease) in liabilities:				
Trade accounts payable	2,365	2,552	(319)	
Other payables	(109,312)	(117,946)	3,450	
Advance receipts	(3,133)	(3,380)	(8,821)	
Withholdings	(7,310)	(7,887)	(10,063)	
Value added tax withholdings	8,188	8,835	36,730	
Accrued expenses	4,399	4,746	(1,660)	
Tobacco excise taxes and dues payable	198,741	214,438	111,200	
Income taxes payable	68,800	74,234	18,731	
Other, net	27	28	653	
Net cash provided by operating activities	<u>405,970</u>	<u>438,034</u>	<u>351,398</u>	

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Cash Flows, Continued

For the three-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	2007		2006
	Korean Won	U.S. dollars (note 2)	Korean Won
Cash flows from investing activities (note 24):			
Decrease in short-term financial instruments	₩ 80,000	\$ 86,319	₩ 180,000
Proceeds from sale of available-for-sale securities	1,162	1,254	124
Proceeds from sale of equity method investment securities	-	-	40,148
Decrease in long-term loans to employees, net	6,788	7,324	8,936
Proceeds from sale of property, plant & equipment	4,165	4,494	3,874
Purchases of available-for-sale securities	(218,462)	(235,716)	(1,230)
Increase in long-term deposit in escrow fund	(6,350)	(6,852)	(8,504)
Purchases of property, plant & equipment	(56,532)	(60,997)	(46,700)
Purchases of intangible assets	(92)	(99)	(52)
Other, net	2,395	2,583	(1,185)
Net cash provided by (used in) investing activities	<u>(186,926)</u>	<u>(201,690)</u>	<u>175,411</u>
Cash flows from financing activities (note 24):			
Increase (decrease) in guarantee deposits received	(2,052)	(2,214)	996
Reissuance of treasury stock	-	-	22,763
Reacquisition of treasury stock	(269,410)	(290,689)	
Payment of dividends	<u>(319,712)</u>	<u>(344,963)</u>	<u>(249,703)</u>
Net cash used in financing activities	<u>(591,174)</u>	<u>(637,866)</u>	<u>(225,943)</u>
Net increase (decrease) in cash and cash equivalents	(372,130)	(401,521)	300,867
Cash and cash equivalents at beginning of period	<u>666,163</u>	<u>718,778</u>	<u>391,211</u>
Cash and cash equivalents at end of period	₩ <u>294,033</u>	\$ <u>317,256</u>	₩ <u>692,078</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Changes in Stockholders' Equity

For the six-month periods ended June 30, 2007 and 2006

(Unaudited)

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

	Korean Won						U.S. dollars (note 2)
	Common stock	Capital surplus	Capital adjustments	Accumulated other comprehensive income	Retained earnings	Total	
Balance at January 1, 2006	₩ 954,959	300,043	(349,885)	23,601	2,519,322	3,448,040	
Dividends	-	-	-	-	(249,703)	(249,703)	
Net income	-	-	-	-	252,588	252,588	
Unrealized gain on valuation of available-for-sale securities	-	-	-	(8,601)	-	(8,601)	
Unrealized gain on valuation of equity method investments	-	-	-	(145)	-	(145)	
Unrealized loss on valuation of equity method investments	-	-	-	(945)	-	(945)	
Reacquisition of treasury stock	-	-	(160,819)	-	-	(160,819)	
Retirement of treasury stock	-	-	160,819	-	(160,819)	-	
Compensation by treasury stock	-	9,880	9,135	-	-	19,015	
Balance at June 30, 2006	₩ 954,959	309,923	(340,750)	13,910	2,361,388	3,299,430	
Balance at January 1, 2007	₩ 954,959	335,414	(321,904)	15,784	2,061,520	3,045,772	\$ 3,286,331
Dividends	-	-	-	-	(319,712)	(319,712)	(344,963)
Net income	-	-	-	-	327,730	327,730	353,615
Unrealized gain on valuation of available-for-sale securities	-	-	-	3,715	-	3,715	4,008
Unrealized gain on valuation of equity method investments	-	-	-	5	-	5	5
Unrealized loss on valuation of equity method investments	-	-	-	127	-	127	137
Reacquisition of treasury stock	-	-	(269,410)	-	-	(269,410)	(290,688)
Retirement of treasury stock	-	-	269,410	-	(269,410)	-	-
Compensation by treasury stock	-	4,607	3,331	-	-	7,938	8,565
Balance at June 30, 2007	₩ 954,959	340,020	(318,573)	19,631	1,800,128	2,796,165	\$ 3,017,010

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Non-Consolidated Statements of Changes in Stockholders' Equity, Continued

For the three-month periods ended June 30, 2007 and 2006

(Unaudited)

	Korean Won						U.S. dollars (note 2)
	Common stock	Capital surplus	Capital adjustments	Accumulated other comprehensive income	Retained earnings	Total	
Balance at April 1, 2006	₩ 954,959	300,043	(349,885)	16,168	2,205,317	3,126,602	
Dividends	-	-	-	-	-	-	
Net income	-	-	-	-	156,071	156,071	
Unrealized gain on valuation of available-for-sale securities	-	-	-	(2,176)	-	(2,176)	
Unrealized loss on valuation of equity method investments	-	-	-	(82)	-	(82)	
Compensation by treasury stock	-	9,880	9,135	-	-	19,015	
Balance at June 30, 2006	₩ <u>954,959</u>	<u>309,923</u>	<u>(340,750)</u>	<u>13,910</u>	<u>2,361,388</u>	<u>3,299,430</u>	
Balance at April 1, 2007	₩ 954,959	340,020	(318,573)	19,092	1,871,992	2,867,490	\$ 3,093,968
Dividends	-	-	-	-	-	-	-
Net income	-	-	-	-	197,546	197,546	213,149
Unrealized gain on valuation of available-for-sale securities	-	-	-	608	-	608	655
Unrealized loss on valuation of equity method investments	-	-	-	(69)	-	(69)	(74)
Reacquisition of treasury stock	-	-	(269,410)	-	-	(269,410)	(290,688)
Retirement of treasury stock	-	-	269,410	-	(269,410)	-	-
Compensation by treasury stock	-	-	-	-	-	-	-
Balance at June 30, 2007	₩ <u>954,959</u>	<u>340,020</u>	<u>(318,573)</u>	<u>19,631</u>	<u>1,800,128</u>	<u>2,796,165</u>	\$ <u>3,017,010</u>

See accompanying notes to non-consolidated financial statements.

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements

June 30, 2007 and 2006

(Unaudited)

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

(a) Origination and Description of Business

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

As of June 30, 2007, the 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 Company has two plants for fabrication of leaf tobacco, including the Nam Won plant, and the Chun Ahn printing plant for the manufacturing of wrapping paper.

Pursuant to the Korean government's privatization program and management reorganization plan, on December 28, 1998, the stockholders approved a plan to separate the 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 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 Company listed 35,816,658 and 45,400,000 Global Depository Shares ("GDS") (each GDS representing the right to receive one-half share of common stock of the Company), respectively, on the Luxembourg Stock Exchange pursuant to the Korean government's privatization program.

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

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

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

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

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

The Company maintains its accounting records in Korean Won and prepares statutory non-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 non-consolidated financial statements have been condensed, restructured and translated into English from the Korean language non-consolidated financial statements.

Certain information included in the Korean language non-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 non-consolidated financial statements.

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

(c) Cash Equivalents

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

(d) Financial Instruments

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

(e) Allowance for Doubtful Accounts

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

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

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

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-process; using the moving-average method for raw materials and supplies; and using the specific identification method for goods-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. The amount of any write-down of inventories to net realizable value due to obsolescence or excess inventory and other losses of inventories occurring in the normal course of business is 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 ₩18,911millions and ₩17,294millions, respectively, for the six-month period ended June 30, 2007. Also, the estimated amounts of inventories in current assets, which will not be realized in a year or less, are ₩282,043millions and ₩411,239millions, respectively, as of June 30, 2007 and December 31, 2006.

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

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

(g) Investment in Securities

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

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

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

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(1) Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued(g) Investment in Securities, Continued

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

(h) Investment Securities under the Equity Method of Accounting

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

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

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

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

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

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(1) Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued(i) Property, Plant and Equipment

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

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

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

	<u>Useful lives (years)</u>
Buildings	10 to 60
Structures	10 to 40
Machinery and equipment	10 to 12
Vehicles and other transportation equipment	4
Tools	4
Furniture and fixtures	4

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

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

(j) Intangible Assets

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

(i) Research and Development Costs

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

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(1) Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued(j) Intangible Assets, Continued(ii) Other Intangible Assets

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

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

(k) 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.

(l) Retirement and Severance Benefits

Employees who have been with the Company for more than one year are entitled to lump-sum payments based on current salary rates and length of service when they leave the Company. The Company's estimated liability under the plan which would be payable if all employees left on the balance sheet date is accrued in the accompanying non-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 non-consolidated balance sheets as a reduction of the liability for retirement and severance benefits.

(m) 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 ₩928.60 to USD1, the rate of exchange on June 30, 2007 that is permitted by the Financial Accounting Standards. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Korean Won at the foreign exchange rate on the date of the transaction.

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

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(1) Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued(n) Revenue Recognition

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

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

(o) Income Taxes

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

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

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

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

(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) 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.

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

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

The preparation of non-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 non-consolidated financial statements and related notes to non-consolidated financial statements. Actual results could differ from those estimates.

(2) Basis of Translating Financial Statements

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

(3) Inventories

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

	<u>2007</u>	<u>2006</u>
Finished goods, net of allowance for valuation losses	₩ 72,015	90,546
Work-in-process	9,595	9,758
Raw materials, net of allowance for valuation losses	743,606	866,445
Supplies	20,101	19,425
By-products	3,704	4,267
Completed buildings	21,198	2,745
Sites for building lotting-out construction	14,031	11,571
Goods-in-transit	<u>12,918</u>	<u>11,783</u>
	<u>₩ 897,168</u>	<u>1,016,540</u>

(4) Other Current Assets

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

	<u>2007</u>	<u>2006</u>
Accrued income	₩ 1,466	160
Other receivables (note 15)	26,457	24,687
Prepaid expenses	12,423	3,291
Short-term loans to employees (note 7)	17,924	19,194
Advance payments	49,859	1,490
Current portion of financial derivative assets (note 19)	108	-
Available-for-sale securities (note 5)	<u>85</u>	<u>555</u>
	<u>₩ 108,322</u>	<u>49,377</u>

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(5) Available-for-sale Securities

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

(a) Equity securities

Company	Number of shares	Percentage of ownership	Acquisition cost	Fair value (*4)	Book value	
					2007	2006
Marketable securities:						
Yonhap Television News (YTN)	8,380,000	19.95%	₩ 5,102	41,565	41,565	28,366
Crystal Genomics Co., Ltd.	111,000	1.97%	2,875	1,821	1,821	1,582
Oscotech, Inc.	230,770	3.71%	2,250	2,769	2,769	2,250
Shinhan Financial Group	3,500,000	0.92%	205,532	196,700	196,700	-
			215,759	242,855	242,855	32,198
Non-marketable securities:						
Celltrion, Inc.	3,791,368	13.96%	21,245	21,245	21,245	21,245
Nexgen Biotechnologies, Inc. (*1)	1,000,000	11.84%	2,150	-	-	2,150
KT&G Turkey (*2)	9,900	99.00%	16,316	14,981	14,981	869
Cosmo Tobacco Co., Ltd. (*1)	480,000	40.00%	2,540	-	-	-
Innodis, Inc.	110,000	19.64%	55	55	55	55
REXAHN Pharmaceuticals, Inc.	2,500,000	4.97%	2,359	2,359	2,359	2,359
Lifenza, Inc.	29,047	13.01%	1,600	-	-	-
Korea Islet Transplantatio Institute, Inc. (*2)	110,500	48.25%	2,000	2,000	2,000	2,000
KT&G Mongolia LLC (*2)	40,000	100.00%	201	201	201	201
Korea Tabacos do Brasil Ltda. (*2)	(*3)	99.90%	394	394	394	394
Genematrix, Inc.	300,000	10.49%	1,500	1,500	1,500	1,500
Litepharmtech, Inc. (*2)	50,000	29.41%	1,000	1,000	1,000	1,000
Hurum, Inc.	7,800	9.75%	39	39	39	39
MD Bioalpha Co., Ltd.	65,852	5.00%	667	667	667	667
OCT USA, Inc.	48,780	19.97%	927	927	927	927
			52,993	45,368	45,368	33,406
Total			₩ 268,752	288,223	288,223	65,604

(*1) The Company wrote off the common stock of Nexgen Biotechnologies, Inc. as the declines in value judged to be other-than-temporary and recorded a loss ₩2,150 charged to current results of operations in the six-month period ended June 30, 2007. In the prior period, the Company also wrote off investments in Lifenza, Inc. and Cosmo Tobacco Co., Ltd. for the same reason. Other than the above securities, non-marketable securities are recorded at cost since fair value is not available.

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

(*3) Stock certificates are not issued.

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

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

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

Description	Interest rate per annum	Acquisition cost	Fair value	Book value	
				2007	2006
Current assets:					
Government and municipal bonds	3.0 ~ 7.0%	₩ 85	85	85	555
Non-current assets:					
Government and municipal bonds	3.0 ~ 7.0%	2,148	2,148	2,148	2,175
Oscotech, Inc.	10.0%	1,000	1,000	1,000	1,000
Litepharmtech, Inc.	8.0%	1,000	1,000	1,000	1,000
		4,148	4,148	4,148	4,175
		₩ 4,233	4,233	4,233	4,730

(c) Changes in unrealized gains on valuation of available-for-sale securities for the six-month period ended June 30, 2007 are summarized as follows:

	Amount including tax effect	Tax effect	Amount, net of tax effect
Beginning balance	₩ 21,971	(6,042)	15,929
Changes in unrealized gain	5,125	(1,410)	3,715
Ending balance	₩ 27,096	(7,452)	19,644

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

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

Affiliate	Number of shares	Percentage of ownership	2007	2006
Korea Ginseng Corporation	12,985,851	100.00%	₩ 497,183	451,545
Yungjin Pharm. Ind. Co., Ltd.	53,148,564	56.97%	11,014	27,909
Tae-a Industry Co., Ltd.	150,000	100.00%	10,008	10,528
KT&G USA, Inc. (*)	-	-	-	903
			₩ 518,205	490,885

(*) In the 1st quarter of 2007, KT&G USA, Inc.'s securities were reclassified as available-for-sale securities since KT&G USA, Inc. was in the process of liquidation. As the liquidation process completed in the 2nd quarter of 2007, the Company recorded a ₩ 428 gain on disposition of available-for-sale securities.

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

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

- (b) Changes in the difference between the acquisition cost and the Company's share of the investees' identifiable net assets as of June 30, 2007 are as follows:

Affiliate	Beginning balance	Amortized amount	Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩ 1,832	(454)	1,378
Tae-a Industry Co., Ltd.	<u>5,183</u>	<u>(1,036)</u>	<u>4,147</u>
	₩ <u>7,015</u>	<u>(1,490)</u>	<u>5,525</u>

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

Affiliate	Beginning balance	Increase	Realized amount	Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩ 876	1,597	(6)	2,467
Tae-a Industry Co., Ltd.	<u>123</u>	<u>1,075</u>	<u>(897)</u>	<u>301</u>
	₩ <u>999</u>	<u>2,672</u>	<u>(903)</u>	<u>2,768</u>

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

Affiliate	Acquisition cost	Adjustment to				June 30, 2007
		Retained earnings		Unrealized gain (loss)	Other (*)	
		Prior to 2007	2007			
Korea Ginseng Corporation	₩ 214,929	426,433	65,781	(1,060)	(208,900)	497,183
Yungjin Pharm. Ind. Co., Ltd.	32,682	(5,808)	(16,901)	1,041	-	11,014
Tae-a Industry Co., Ltd.	<u>14,198</u>	<u>(3,670)</u>	<u>(520)</u>	<u>-</u>	<u>-</u>	<u>10,008</u>
	₩ <u>261,809</u>	<u>416,955</u>	<u>48,360</u>	<u>(19)</u>	<u>(208,900)</u>	<u>518,205</u>

- (*) The amount consists of the ₩150,000 paid for reduction of capital by cash and ₩58,900 cash dividends.

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(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

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

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

Affiliate	Acquisition cost	Adjustment to			December 31, 2006
		Prior to 2006	Retained earnings 2006	Unrealized gain (loss) Other (*)	
Korea Ginseng Corporation	₩ 214,929	327,236	99,197	(917) (188,900)	451,545
Yungjin Pharm. Ind. Co., Ltd.	32,682	(1,221)	(4,587)	1,035 -	27,909
Tae-a Industry Co., Ltd.	14,198	(2,375)	(1,295)	- -	10,528
KT&G USA, Inc.	584	-	549	(230) -	903
	₩ 262,393	323,640	93,864	(112) (188,900)	490,885

- (*) The amount consists of the ₩150,000 paid for reduction of capital by cash and ₩38,900 cash dividends.

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

Affiliate	Total assets	Total liabilities	Sales	Net income (loss)
Korea Ginseng Corporation	₩ 557,491	60,308	243,218	65,781
Yungjin Pharm. Ind. Co., Ltd.	121,174	99,927	58,585	(25,571)
Tae-a Industry Co., Ltd.	10,359	4,198	6,496	699

- (g) Market price of equity investments in listed affiliated companies as of March 31, 2007 is as follows:

Affiliate	Market price	Book value
Yungjin Pharm. Ind. Co., Ltd.	₩ 107,892	11,014

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(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(7) Transactions and Balances with Related Companies

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

Related company	Description
Korea Ginseng Corporation	The Company's subsidiary
Yungjin Pharm. Ind. Co., Ltd.	The Company's subsidiary
Tae-a Industry Co., Ltd.	The Company's subsidiary
KT&G Turkey	The Company's subsidiary
KT&G Mongolia LLC	The Company's subsidiary
Cosmo Tobacco Co., Ltd.	The Company's subsidiary
Korea Tabacos do Brasil Ltda.	The Company's subsidiary
Korea Islet Transplantation Institute, Inc.	The Company's subsidiary
Korea Ginseng HK, Ltd.	Korea Ginseng Corporation's subsidiary
KGC Sales Co., Ltd.	Korea Ginseng Corporation's subsidiary
Yungjin Distribution Co., Ltd.	Yungjin Pharm. Ind. Co., Ltd.'s subsidiary

The affiliated company relationship with KT&G USA, Inc. was terminated in the six-month period ended June 30, 2007 as the liquidation process of the company was completed.

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

(i) Revenue from sales and others

	Six-month period ended June 30,					
	2007			2006		
	Sales	Other income	Total	Sales	Other income	Total
Korea Ginseng Corporation	₩ 800	6,774	7,574	831	5,253	6,084
Yungjin Pharm. Ind. Co., Ltd.	39	1	40	39	35	74
KT&G USA, Inc.	1,694	-	1,694	6,214	-	6,214
KT&G Turkey	79	-	79	-	-	-
KT&G Mongolia LLC	680	-	680	-	-	-
	<u>₩ 3,292</u>	<u>6,775</u>	<u>10,067</u>	<u>7,084</u>	<u>5,288</u>	<u>12,372</u>
	Three-month period ended June 30,					
	2007			2006		
	Sales	Other income	Total	Sales	Other income	Total
Korea Ginseng Corporation	₩ 568	3,325	3,893	831	2,703	3,534
Yungjin Pharm. Ind. Co., Ltd.	20	-	20	19	16	35
KT&G USA, Inc.	-	-	-	3,863	-	3,863
KT&G Turkey	79	-	79	-	-	-
KT&G Mongolia LLC	452	-	452	-	-	-
	<u>₩ 1,119</u>	<u>3,325</u>	<u>4,444</u>	<u>4,713</u>	<u>2,719</u>	<u>7,432</u>

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(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(7) Transactions and Balances with Related Companies, Continued(ii) Purchases and other expenses

	Six-month period ended June 30,					
	2007			2006		
	Purchases	Other expenses	Total	Purchases	Other expenses	Total
Korea Ginseng Corporation	₩ 930	-	930	809	-	809
Yungjin Pharm. Ind. Co., Ltd.	-	45	45	115	-	115
Tae-a Industry Co., Ltd.	6,496	-	6,496	3,916	-	3,916
KT&G Turkey	74	-	74	-	-	-
Korea Tabacos do Brasil Ltda.	-	48	48	-	73	73
	₩ 7,500	93	7,593	4,840	73	4,913

	Three-month period ended June 30,					
	2007			2006		
	Purchases	Other expenses	Total	Purchases	Other expenses	Total
Korea Ginseng Corporation	₩ 529	-	529	273	-	273
Yungjin Pharm. Ind. Co., Ltd.	-	18	18	113	-	113
Tae-a Industry Co., Ltd.	3,545	-	3,545	1,339	-	1,339
KT&G Turkey	74	-	74	-	-	-
Korea Tabacos do Brasil Ltda.	-	20	20	-	43	43
	₩ 4,148	38	4,186	1,725	43	1,768

(iii) Due from affiliates

	2007			2006		
	Trade accounts receivable	Other	Total	Trade accounts receivable	Other	Total
	KT&G USA Inc.	₩ -	-	-	9,192	-
KT&G Turkey	-	-	-	-	1,249	1,249
KT&G Mongolia LLC	451	238	689	232	238	470
	₩ 451	238	689	9,424	1,487	10,911

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June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(7) Transactions and Balances with Related Companies, Continued(iv) Due to affiliates

	2007			2006		
	Trade accounts payable	Other	Total	Trade accounts payable	Other	Total
Korea Ginseng Corporation	₩ 7	3,998	4,005	13	2,820	2,833
Tae-a Industry Co., Ltd.	1,387	-	1,387	-	-	-
	₩ 1,394	3,998	5,392	13	2,820	2,833

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

	2007	2006
Loans for employee housing and education	₩ 31,485	33,075
Loans to Employee Stock Ownership Association	14,512	24,906
Other	38,592	22,319
	₩ 84,589	80,300

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

	2007	2006
Short-term payroll	₩ 2,125	1,062
Post-retirement pay	3,285	999
	₩ 5,410	2,061

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

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

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Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(8) Long-term Loans Receivable

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

Classification	Interest rate per annum	Maturity date	June 30, 2007	December 31, 2006
Loan to National Leaf Tobacco Growers Cooperative Federation in support of leaf tobacco cultivation (*1)	0.7%	2007.11.20	₩ 110,000	110,000
Loan to Korea Ginseng Cooperative Federation in support of ginseng cultivation	1.5%	2007.12.21	1,400	1,400
			111,400	111,400
Less present value discount account (*2)			(4,976)	(11,416)
allowance for doubtful accounts			(1,064)	(1,000)
Total net realizable present value (Current portion)			₩ 105,360	98,984

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

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

(9) Property, Plant and Equipment

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

	January 1, 2007	Acquisition	Disposal	Depreciation	Others(*)	June 30, 2007
Land	₩ 353,865	232	(3,096)	-	1,762	352,763
Buildings	460,511	2,715	(3,553)	(10,886)	23,566	472,353
Structures	23,194	125	(182)	(975)	745	22,907
Machinery and equipment	332,553	2,235	(1,923)	(33,070)	12,312	312,107
Vehicles and other transportation equipment	5,322	259	(191)	(1,711)	46	3,725
Tools	10,010	1,150	-	(2,242)	-	8,918
Furniture and fixtures	75,235	15,227	(40)	(17,914)	73	72,581
Construction-in-progress	83,002	64,231	-	-	(38,655)	108,578
Other tangible fixed assets	464	9	-	-	-	473
	₩ 1,344,156	86,183	(8,985)	(66,798)	(151)	1,354,405

(*) Other changes in property, plant and equipment except those transferred from construction-in-progress for the six-month period ended June 30, 2007 comprises the amounts transferred to intangible assets.

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June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(9) Property, Plant and Equipment, Continued

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

	January 1, 2006	Acquisition	Disposal	Depreciation	Others (*)	December 31, 2006
Land	₩ 331,750	21,642	(3,286)	-	3,759	353,865
Buildings	435,769	13,146	(15,128)	(20,199)	46,923	460,511
Structures	23,482	546	(360)	(1,967)	1,493	23,194
Machinery and equipment	279,641	4,342	(1,685)	(59,756)	110,011	332,553
Vehicles and other transportation equipment	8,512	498	(85)	(3,665)	62	5,322
Tools	9,913	1,777	(103)	(3,948)	2,371	10,010
Furniture and fixtures	72,344	31,929	(94)	(30,802)	1,858	75,235
Construction-in-progress	74,827	185,161	-	-	(176,986)	83,002
Other tangible fixed assets	457	-	-	-	7	464
	<u>₩ 1,236,695</u>	<u>259,041</u>	<u>(20,741)</u>	<u>(120,337)</u>	<u>(10,502)</u>	<u>1,344,156</u>

(*) Other changes in property, plant and equipment except those transferred from construction-in-progress for the year ended December 31, 2006 are as follows:

	Amount
Impairment losses on property, plant and equipment	₩ 205
Transferred to site for building lotting-out construction	9,893
Transferred to intangible assets	404
	<u>₩ 10,502</u>

(10) Officially Declared Value of Land

The officially declared value of land at June 30, 2007, as announced by the Minister of Construction and Transportation, is ₩1,297,656. The officially declared value, which is used for government purposes, is not intended to represent fair value.

(11) Insurance

Buildings, structures, machinery and inventories were insured against fire damage up to ₩998,935 as of June 30, 2007 with DongBu Insurance Co., Ltd. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

KT&G CORPORATION

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(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(12) Other Assets

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

	<u>2007</u>	<u>2006</u>
Long-term accrued interest	₩ 70	27
Long-term other receivables	1,688	-
Long-term loans to affiliates	<u>239</u>	<u>1,487</u>
	₩ <u>1,997</u>	<u>1,514</u>

(13) Other Current Liabilities

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

	<u>2007</u>	<u>2006</u>
Withholdings	₩ 4,446	7,371
Advance receipts	10,024	7,113
Unearned income (note 7)	<u>347</u>	<u>915</u>
	₩ <u>14,817</u>	<u>15,399</u>

(14) Retirement and Severance Benefits

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

	<u>2007</u>	<u>2006</u>
Estimated retirement and severance benefits accrual at beginning of period	₩ 173,332	132,891
Provision for retirement and severance benefits	12,960	47,765
Payments (*)	<u>(14,581)</u>	<u>(7,324)</u>
Estimated retirement and severance benefits accrual at end of period	171,711	173,332
Deposit for severance benefits trust	<u>(94,398)</u>	<u>(95,635)</u>
Net balance at end of period	₩ <u>77,313</u>	<u>77,697</u>

(*) Compensations paid by treasury stock amounting to ₩6,336 for the six-month period ended June 30, 2007 are included.

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(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(14) Retirement and Severance Benefits, Continued

The Company maintains an employees' severance benefit trust arrangements with Samsung Life Insurance Co., Ltd. and other insurance companies. Under these arrangements, the Company has made an aggregate deposit in the amount equal to 55.0% and 55.2% of the reserve balances of retirement and severance benefits as of June 30, 2007 and December 31, 2006, respectively. This deposit is to be used to make the required payments to the retirees and accounted for as a reduction of the reserve balance.

(15) Assets and Liabilities Denominated in Foreign Currencies

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

		<u>Foreign currency</u>		<u>Korean Won equivalent</u>	
		<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Assets:					
Cash and cash equivalents	USD	3,896	278	₩ 3,611	258
Trade accounts receivable	USD	127,287	107,248	117,969	99,698
	HKD	700	1,495	83	179
Other receivables	USD	259	134	240	125
Long-term deposits in Escrow Fund	USD	64,463	49,065	<u>59,744</u>	<u>45,611</u>
Total				₩ <u>181,647</u>	<u>145,871</u>
Liabilities:					
Trade accounts payable	USD	2,778	5,320	2,575	4,945
	EUR	2,852	-	3,553	-
	GBP	-	96	-	<u>175</u>
				₩ <u>6,128</u>	<u>5,120</u>

(16) Capital Adjustments

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

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

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(17) Other Accumulated Comprehensive Income

Other accumulated comprehensive income as of June 30, 2007 and December 31, 2006 are summarized as follows:

	<u>2007</u>	<u>2006</u>
Unrealized gain on valuation of available-for-sale securities (note 5)	₩ 19,644	15,929
Unrealized gain on valuation of equity method investments	755	750
Unrealized loss on valuation of equity method investments	<u>(768)</u>	<u>(895)</u>
	₩ <u>19,631</u>	<u>15,784</u>

(18) Retained Earnings

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

	<u>2007</u>	<u>2006</u>
Legal reserve	₩ 602,937	602,937
Reserve for business expansion	698,881	698,881
Reserve for business rationalization	12,851	12,851
Reserve for research and human resource development	45,000	45,000
Reserve for loss on reissuance of treasury stock	26,646	26,646
Other appropriations	350,000	880,000
Unappropriated (undisposed) retained earnings (deficit) at end of period	<u>63,813</u>	<u>(204,796)</u>
	₩ <u>1,800,128</u>	<u>2,061,519</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 may be transferred to common stock in connection with a free issue of shares.

(b) Reserve for Business Expansion

Reserve for business expansion was a legal reserve under the old Korea Tobacco and Ginseng Corporation Act, which was abrogated on September 1, 1997. Consequently, the existing balance has been regarded as a voluntary reserve since then.

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(Unaudited)

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(18) Retained Earnings, Continued(c) Reserve for Business Rationalization

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

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

(d) Other Reserves

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

(19) Commitments and Contingencies

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

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

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

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

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

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(19) Commitments and Contingencies, Continued

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

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

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

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

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

(20) Reserve for Tobacco Production Stabilization Fund

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

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

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

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

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(21) Building Lotting-out Construction Contracts

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

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

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

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

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

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

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(22) Income Taxes

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

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

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

	<u>2007</u>		<u>2006</u>	
	<u>Three months</u>	<u>Six months</u>	<u>Three months</u>	<u>Six months</u>
Current income tax expense	₩ 69,550	115,972	60,306	92,334
Deferred income tax expense	(1,566)	9,758	8,529	6,164
Income tax expense charged directly to stockholders' equity	<u>(204)</u>	<u>(3,119)</u>	<u>(2,923)</u>	<u>(486)</u>
	<u>₩ 67,780</u>	<u>122,611</u>	<u>65,912</u>	<u>98,012</u>

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

	<u>2007</u>	<u>2006</u>
Provision for income taxes at normal tax rate	₩ 123,837	96,495
Tax effects of permanent differences	(4,059)	1,274
Tax credit	(2,526)	(479)
Changes in valuation allowances for deferred income tax assets (liabilities) arisen from equity in income of affiliates	5,359	820
Other	<u>-</u>	<u>(98)</u>
Actual provision for income taxes	<u>₩ 122,611</u>	<u>98,012</u>

The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 27.2% and 28.0% for the six-month periods ended June 30, 2007 and 2006, respectively.

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(22) Income Taxes, Continued

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

	<u>2007</u>	<u>2006</u>
Deferred income tax assets:		
Provision for severance and retirement benefits	₩ 30,693	28,681
Loss on valuation of inventories	5,699	5,384
Depreciation	3,754	4,404
Bad debts	887	1,096
Impairment losses on property, plant and equipment	279	754
Present value discounts	1,368	3,140
Provision for Tobacco Production Stabilization Fund	22,940	20,483
Other	<u>5,137</u>	<u>4,342</u>
Total deferred tax assets	<u>70,757</u>	<u>68,284</u>
Deferred income tax liabilities:		
Accrued income	(392)	(35)
Deposit for severance and retirement benefits insurance	(25,960)	(26,300)
Reserve for research and manpower development	(10,313)	(12,375)
Equity method investment securities	(99,991)	(86,984)
Reserve for losses on reissuance of treasury stock	(7,328)	(7,328)
Available-for-sale securities	(7,452)	(6,042)
Treasury stock	(15,531)	(15,636)
Other	<u>(633)</u>	<u>(622)</u>
Total deferred tax liabilities	<u>(167,600)</u>	<u>(155,322)</u>
Net deferred tax liabilities	(96,842)	(87,038)
Less current portion	<u>(7,788)</u>	<u>(7,760)</u>
Deferred tax liabilities	<u>₩ (104,630)</u>	<u>(94,798)</u>

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

	<u>2007</u>	<u>2006</u>
Gain on reissuance of treasury stock	₩ (1,747)	(3,748)
Unrealized gain on valuation of available-for-sale securities	(1,409)	3,262
Unrealized gain on valuation of equity method investments	(2)	-
Unrealized loss on valuation of equity method investments	<u>39</u>	<u>-</u>
	<u>₩ (3,119)</u>	<u>(486)</u>

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(22) Income Taxes, Continued

- (e) Deferred tax assets have been recognized because it is probable that future profit will be available against which the Company can utilize the related benefit.
- (f) Under SKAS No. 16, the deferred tax amounts should be presented as a net current asset or liability and a net non-current asset or liability. In addition, the Company is required to disclose aggregate deferred tax assets (liabilities). As of June 30, 2007, details of aggregate deferred tax assets (liabilities) are as follows:

	Temporary differences at June 30, 2007	Deferred tax assets (liabilities)	
		Current	Non-current
Assets:			
Provision for severance and retirement benefits	₩ 111,614	-	30,693
Loss on valuation of inventories	20,722	5,699	-
Depreciation	13,654	-	3,754
Bad debts	3,225	887	-
Impairment losses on property, plant and equipment	1,014	-	279
Present value discounts	4,977	-	1,368
Provision for Tobacco Production Stabilization Fund	83,419	-	22,940
Other	18,673	1,624	3,513
	<u>257,298</u>	<u>8,210</u>	<u>62,547</u>
Liabilities:			
Accrued income	(1,426)	(392)	-
Deposit for severance and retirement benefits insurance	(94,402)	-	(25,960)
Reserve for research and human resource development	(37,500)	-	(10,313)
Equity method investment securities	(390,675)	-	(99,991)
Reserve for losses on reissuance of treasury stock	(26,646)	-	(7,328)
Available-for-sale securities	(27,096)	-	(7,452)
Treasury stock	(56,475)	-	(15,531)
Other	(2,300)	(30)	(603)
	<u>(636,520)</u>	<u>(422)</u>	<u>(167,178)</u>
	₩ <u>(379,222)</u>	<u>7,788</u>	<u>(104,630)</u>

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(23) Earnings Per Share

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

	2007		2006	
	Three months	Six months	Three months	Six months
Net income per accompanying statements of income	₩ 197,545	327,730	156,071	252,588
Weighted-average number of common shares outstanding	<u>132,264,686</u>	<u>132,741,625</u>	<u>144,088,240</u>	<u>144,658,772</u>
Earnings per share in Korean Won	₩ <u>1,494</u>	<u>2,469</u>	<u>1,083</u>	<u>1,746</u>

(24) Non-cash Investing and Financing Activities

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

	2007	2006
Construction-in-progress transferred to property, plant and equipment	₩ 38,655	57,230
Retirement of treasury stock	269,410	160,819
Compensation by treasury stock	9,335	-

(25) Added Value

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

	2007		2006	
	Three months	Six months	Three months	Six months
Wages and salaries	₩ 75,954	151,993	64,055	137,767
Provision for severance benefits	10,906	12,960	8,191	11,634
Employee welfare	6,480	13,540	5,612	12,199
Rent	3,050	6,253	2,827	5,706
Depreciation	33,364	66,798	29,447	58,309
Taxes and dues	5,456	9,416	6,257	9,846

KT&G CORPORATION

Notes to Non-Consolidated Financial Statements, Continued

June 30, 2007 and 2006

(Unaudited)

(In millions of Korean Won and thousand of U.S. dollars, except where otherwise stated and share data)

(26) Employee Welfare and Contributions to Society

For employee welfare, the Company maintains a refectory, an infirmary, athletic facilities, a scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spent for the six-month periods ended June 30, 2007 and 2006 are estimated at ₩13,540 and ₩12,199, respectively.

The Company donated ₩6,805 and ₩41,212 to KT&G Social Welfare Foundation and others for the six-month periods ended June 30, 2007 and 2006, respectively.

(27) Selling, General and Administrative Expenses

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

	<u>2007</u>		<u>2006</u>	
	<u>Three months</u>	<u>Six months</u>	<u>Three months</u>	<u>Six months</u>
Salaries	₩ 45,451	90,228	39,483	81,812
Provision for severance benefits	7,946	9,378	4,844	7,739
Welfare	3,658	7,505	3,074	6,767
Travel	1,582	2,646	1,142	2,000
Communications	1,046	2,117	945	1,852
Utilities	1,060	2,895	1,190	3,009
Taxes and dues	4,882	8,184	4,512	8,741
Supplies	594	1,205	582	1,114
Uniform	33	34	79	79
Rent	1,196	2,549	977	2,009
Depreciation	13,662	26,999	11,829	22,845
Amortization	180	355	203	404
Repairs and maintenance	1,699	2,272	1,718	2,322
Vehicles	1,762	3,398	1,802	3,388
Insurance	139	301	219	340
Commissions	14,049	29,122	17,589	30,357
Transportation and warehousing	6,392	13,053	5,089	9,706
Entertainment	146	278	151	256
Conferences	686	1,318	695	1,236
Advertising	31,546	61,366	32,567	57,364
Training	2,176	4,044	1,622	2,953
Prizes and rewards	600	1,057	348	673
Cooperation	171	348	120	243
Normal research and development	3,755	6,662	3,574	6,689
Sample	1	1	1	2
Bad debts	243	11	-	110
Miscellaneous	167	320	149	285
	₩ <u>144,822</u>	<u>277,646</u>	<u>134,504</u>	<u>254,295</u>