

KT&G CORPORATION

Separate Interim Financial Statements

September 30, 2016 and 2015

(Unaudited)

(With Independent Auditors' Review Report Thereon)

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Independent Auditors' Review Report

Based on a report originally issued in Korean

The Board of Directors and Shareholders
KT&G Corporation:

Reviewed financial statements

We have reviewed the accompanying separate interim financial statements of KT&G Corporation (the "Company"), expressed in Korean won, which comprise the separate interim statement of financial position as of September 30, 2016, the separate interim statements of comprehensive income for the three- and nine-month periods ended September 30, 2016 and 2015 and the separate interim statements of changes in equity and cash flows for the nine-month periods ended September 30, 2016 and 2015 and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's responsibility

Management is responsible for the preparation and fair presentation of these separate interim financial statements in accordance with Korean International Financial Reporting Standards ("K-IFRS") No.1034 *Interim Financial Reporting*, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' review responsibility

Our responsibility is to issue a report on these separate interim financial statements based on our reviews.

We conducted our reviews in accordance with the Review Standards for Quarterly and Semiannual Financial Statements established by the Securities and Futures Commission of the Republic of Korea. A review of separate interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Korean Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our reviews, nothing has come to our attention that causes us to believe that the accompanying separate interim financial statements referred to above are not prepared, in all material respects, in accordance with K-IFRS No.1034.

The accompanying separate interim financial statements as of and for the three- and nine-month periods ended September 30, 2016 have been translated into United States dollars solely for the convenience of the reader and such translation does not comply with K-IFRS. We have reviewed the translation and nothing came to our attention that causes us to believe that the separate interim financial statements expressed in Korean won have not been translated into dollars on the basis set forth in note 4 to the separate interim financial statements.



Other matters

The procedures and practices utilized in the Republic of Korea to review such separate interim financial statements may differ from those generally accepted and applied in other countries.

The separate statement of financial position of the Company as of December 31, 2015, and the related separate statements of comprehensive income, changes in equity and cash flows for the year then ended, which are not accompanying this report, were audited by us in accordance with Korean Standards on Auditing and our report thereon dated February 25, 2016, expressed an unqualified opinion. The accompanying separate statement of financial position of the Company as of December 31, 2015, presented for comparative purposes, is consistent, in all material respects, with the audited separate financial statements from which it has been derived.

KPMG Samjong Accounting Corp.

KPMG Samjong Accounting Corp.
Seoul, Korea
November 14, 2016

This report is effective as of November 14, 2016, 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 separate interim financial statements and notes thereto. Accordingly, the readers of the review report should understand that the above review report has not been updated to reflect the impact of such subsequent events or circumstances, if any.

KT&G CORPORATION
 Separate Interim Statements of Financial Position
 (Unaudited)

As of September 30, 2016 and December 31, 2015

<i>In millions of won and thousands of U.S. dollars</i>	<i>Note</i>	September 30 2016 Korean won	September 30 2016 U.S. dollars (note 4)	December 31 2015 Korean won
Assets				
Property, plant and equipment	5	₩ 1,190,500	\$ 1,085,926	₩ 1,309,632
Intangible assets	6	28,152	25,679	22,494
Investment property	7,16	254,899	232,508	136,801
Investments in associates	8	39,230	35,784	46,230
Investments in subsidiaries	9	1,153,361	1,052,049	1,124,446
Available-for-sale financial assets	10,31	356,684	325,353	340,149
Long-term deposits in MSA Escrow Fund	11,31,33	444,696	405,634	403,966
Long-term prepaid expenses		5,731	5,226	6,706
Long-term trade and other receivables	12,30,31	69,999	63,850	78,600
Total non-current assets		3,543,252	3,232,009	3,469,024
Inventories	13	824,054	751,668	889,035
Current available-for-sale financial assets	10,31	1,500	1,368	-
Other financial assets	14,31,32	1,070,000	976,010	1,091,976
Prepaid tobacco excise and other taxes		439,493	400,888	447,771
Trade and other receivables	12,30,31	1,172,614	1,069,611	1,074,862
Advance payments		43,246	39,447	26,489
Prepaid expenses		3,745	3,416	4,152
Cash and cash equivalents	14,31,32	467,290	426,243	444,376
Total current assets		4,021,942	3,668,651	3,978,661
Not-current assets held for sale	15	-	-	1,542
Total assets		₩ 7,565,194	\$ 6,900,660	₩ 7,449,227

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION

Separate Interim Statements of Financial Position, Continued

(Unaudited)

As of September 30, 2016 and December 31, 2015

<i>In millions of won and thousands of U.S. dollars</i>	<i>Note</i>	September 30 2016 Korean won	September 30 2016 U.S. dollars (note 4)	December 31 2015 Korean won
Equity				
Ordinary shares	1,17	₩ 954,959	\$ 871,075	₩ 954,959
Other capital surplus	17	3,582	3,268	3,582
Treasury shares	18	(331,772)	(302,628)	(337,062)
Gain on reissuance of treasury shares	18	505,192	460,815	494,648
Reserves	19	4,354,369	3,971,877	3,784,467
Retained earnings	20	737,987	673,162	995,886
Total equity		6,224,317	5,677,569	5,896,480
Liabilities				
Long-term trade and other payables	16,21,30,31	4,185	3,817	8,147
Long-term advance receipts		220	200	491
Net defined benefit liability	23	59,549	54,318	42,174
Deferred income tax liabilities		68,775	62,734	72,179
Total non-current liabilities		132,729	121,069	122,991
Short-term borrowings	22,31,32	4,401	4,014	5,031
Trade and other payables	16,21,30,31	434,750	396,561	433,824
Advance receipts	24	2,325	2,120	26,024
Income tax payable		94,356	86,068	199,767
Tobacco excise and other taxes payable		672,316	613,259	765,110
Total current liabilities		1,208,148	1,102,022	1,429,756
Total liabilities		1,340,877	1,223,091	1,552,747
Total equity and liabilities		₩ 7,565,194	\$ 6,900,660	₩ 7,449,227

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION
 Separate Interim Statements of Comprehensive Income
 (Unaudited)

For the nine-month periods ended September 30, 2016 and 2015

*In millions of won
 and thousands of U.S. dollars,
 except earnings per share*

	Note	2016 Korean won	2016 U.S. dollars (note 4)	2015 Korean won
Sales:	24,30,33			
Manufacture of tobacco		₩ 2,012,771	\$ 1,835,967	₩ 1,999,179
Real estate		106,665	97,295	99,241
Exports of leaf tobacco and others		81,124	73,999	50,443
		2,200,560	2,007,261	2,148,863
Cost of sales:	24,25,30			
Manufacture of tobacco		(643,704)	(587,160)	(609,699)
Real estate		(62,156)	(56,697)	(57,650)
Exports of leaf tobacco and others		(48,631)	(44,359)	(34,669)
		(754,491)	(688,216)	(702,018)
Gross profit		1,446,069	1,319,045	1,446,845
Selling, general and administrative expenses	25,30	(446,688)	(407,451)	(479,820)
Operating profit		999,381	911,594	967,025
Other income	26,30	44,383	40,485	108,920
Other expenses	26,30	(112,987)	(103,062)	(38,084)
Finance income	27,31	44,135	40,258	38,364
Finance costs	27,31	(503)	(458)	(703)
Net finance income	27	43,632	39,800	37,661
Profit before income tax		974,409	888,817	1,075,522
Income tax expense	28	(236,405)	(215,640)	(262,257)
Profit for the period		₩ 738,004	\$ 673,177	₩ 813,265
Other comprehensive income (loss):				
Items that will never be reclassified to profit or loss				
Remeasurements of net defined benefit liability, net of tax		₩ (17)	\$ (16)	₩ (66)
Items that are or may be reclassified subsequently to profit or loss				
Unrealized net changes in fair value of available-for-sale financial assets, net of tax		2,300	2,098	(7,569)
Other comprehensive income (loss) for the period, net of tax		2,283	2,082	(7,635)
Total comprehensive income for the period		₩ 740,287	\$ 675,259	₩ 805,630
Earnings per share in won and U.S. dollars:				
Basic and diluted	29	₩ 5,851	\$ 5.34	₩ 6,457

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION

Separate Interim Statements of Comprehensive Income, Continued

(Unaudited)

For the three-month periods ended September 30, 2016 and 2015

*In millions of won
and thousands of U.S. dollars,
except earnings per share*

	Note	2016 Korean won	2016 U.S. dollars (note 4)	2015 Korean won
Sales:	24,30,33			
Manufacture of tobacco		₩ 695,018	\$ 633,967	₩ 663,603
Real estate		32,422	29,574	19,888
Exports of leaf tobacco and others		26,386	24,068	19,310
		753,826	687,609	702,801
Cost of sales:	24,25,30			
Manufacture of tobacco		(220,465)	(201,099)	(218,406)
Real estate		(18,267)	(16,662)	(8,740)
Exports of leaf tobacco and others		(15,631)	(14,258)	(12,699)
		(254,363)	(232,019)	(239,845)
Gross profit		499,463	455,590	462,956
Selling, general and administrative expenses	25,30	(150,180)	(136,988)	(146,585)
Operating profit		349,283	318,602	316,371
Other income	26,30	6,958	6,346	61,641
Other expenses	26,30	(89,849)	(81,957)	(6,035)
Finance income	27,31	9,874	9,006	10,808
Finance costs	27,31	(157)	(143)	(284)
Net finance income	27	9,717	8,863	10,524
Profit before income tax		276,109	251,854	382,501
Income tax expense	28	(68,121)	(62,136)	(93,620)
Profit for the period		₩ 207,988	\$ 189,718	₩ 288,881
Other comprehensive income (loss):				
Items that will never be reclassified to profit or loss				
Remeasurements of net defined benefit liability, net of tax		₩ 62	\$ 57	₩ 54
Items that are or may be reclassified subsequently to profit or loss				
Unrealized net changes in fair value of available-for-sale financial assets, net of tax		6,880	6,276	(159)
Other comprehensive income (loss) for the period, net of tax		6,942	6,333	(105)
Total comprehensive income for the period		₩ 214,930	\$ 196,051	₩ 288,776
Earnings per share in won and U.S. dollars:				
Basic and diluted	29	₩ 1,649	\$ 1.50	₩ 2,293

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION

Separate Interim Statements of Changes in Equity

(Unaudited)

For the nine-month period ended September 30, 2016

<i>In millions of won</i>		Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2016	₩	954,959	3,582	(337,062)	494,648	3,784,467	995,886	5,896,480
Total comprehensive income for the period:								
Profit for the period		-	-	-	-	-	738,004	738,004
Other comprehensive income (loss):								
Remeasurements of net defined benefit liability, net of tax		-	-	-	-	-	(17)	(17)
Unrealized net changes in fair value of available-for-sale financial assets, net of tax		-	-	-	-	2,300	-	2,300
Total other comprehensive income (loss)		-	-	-	-	2,300	(17)	2,283
Total comprehensive income for the period		-	-	-	-	2,300	737,987	740,287
Transactions with owners, recorded directly in equity:								
Dividends		-	-	-	-	-	(428,284)	(428,284)
In-kind donation of treasury shares		-	-	5,290	10,544	-	-	15,834
Transfer from reserve for research and human resource development		-	-	-	-	(10,000)	10,000	-
Transfer to unconditional reserve		-	-	-	-	577,602	(577,602)	-
Total transactions with owners		-	-	5,290	10,544	567,602	(995,886)	(412,450)
Balance at September 30, 2016	₩	954,959	3,582	(331,772)	505,192	4,354,369	737,987	6,224,317

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION

Separate Interim Statements of Changes in Equity, Continued

(Unaudited)

For the nine-month period ended September 30, 2016

In thousands of U.S. dollars

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2016	\$ 871,075	3,268	(307,454)	451,198	3,452,036	908,407	5,378,530
Total comprehensive income for the period:							
Profit for the period	-	-	-	-	-	673,177	673,177
Other comprehensive income (loss):							
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	(16)	(16)
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	2,098	-	2,098
Total other comprehensive income (loss)	-	-	-	-	2,098	(16)	2,082
Total comprehensive income for the period	-	-	-	-	2,098	673,161	675,259
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(390,663)	(390,663)
In-kind donation of treasury shares	-	-	4,826	9,617	-	-	14,443
Transfer from reserve for research and human resource development	-	-	-	-	(9,122)	9,122	-
Transfer to unconditional reserve	-	-	-	-	526,865	(526,865)	-
Total transactions with owners	-	-	4,826	9,617	517,743	(908,406)	(376,220)
Balance at September 30, 2016	\$ 871,075	3,268	(302,628)	460,815	3,971,877	673,162	5,677,569

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION

Separate Interim Statements of Changes in Equity, Continued

(Unaudited)

For the nine-month period ended September 30, 2015

<i>In millions of won</i>		Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2015	₩	954,959	3,582	(339,059)	492,032	3,493,758	736,461	5,341,733
Total comprehensive income for the period:								
Profit for the period		-	-	-	-	-	813,265	813,265
Other comprehensive loss:								
Remeasurements of net defined benefit liability, net of tax		-	-	-	-	-	(66)	(66)
Unrealized net changes in fair value of available-for-sale financial assets, net of tax		-	-	-	-	(7,569)	-	(7,569)
Total other comprehensive loss		-	-	-	-	(7,569)	(66)	(7,635)
Total comprehensive income (loss) for the period		-	-	-	-	(7,569)	813,199	805,630
Transactions with owners, recorded directly in equity:								
Dividends		-	-	-	-	-	(428,056)	(428,056)
In-kind donation of treasury shares		-	-	1,997	2,616	-	-	4,613
Transfer from reserve for research and human resource development		-	-	-	-	(12,522)	12,522	-
Transfer to unconditional reserve		-	-	-	-	320,926	(320,926)	-
Total transactions with owners		-	-	1,997	2,616	308,404	(736,460)	(423,443)
Balance at September 30, 2015	₩	954,959	3,582	(337,062)	494,648	3,794,593	813,200	5,723,920

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION
 Separate Interim Statements of Cash Flows
 (Unaudited)

For the nine-month periods ended September 30, 2016 and 2015

<i>In millions of won and thousands of U.S. dollars</i>	<i>Note</i>	2016 Korean won	2016 U.S. dollars (note 4)	2015 Korean won
Cash flows from operating activities				
Cash generated from operations	34	₩ 892,745	\$ 814,325	₩ 1,318,153
Income tax paid		(349,318)	(318,633)	(282,533)
Net cash provided by operating activities		543,427	495,692	1,035,620
Cash flows from investing activities				
		34		
Interest received		27,086	24,706	22,695
Dividends received		13,798	12,586	11,680
Proceeds from sale of property, plant and equipment		10,671	9,733	6,671
Proceeds from sale of intangible assets		182	166	1,592
Proceeds from sale of non-current assets held for sale		5,800	5,291	4,260
Proceeds from investments in associates		13,095	11,945	-
Collection of loans		10,287	9,383	8,929
Withdrawal of guarantee deposits		10,781	9,835	19,468
Acquisition of property, plant and equipment		(84,223)	(76,825)	(105,518)
Acquisition of intangible assets		(5,826)	(5,314)	(1,957)
Acquisition of investment property		-	-	(64)
Acquisition of investments in subsidiaries		(1,500)	(1,368)	(54,851)
Acquisition of available-for-sale financial assets		(15,000)	(13,682)	(28,200)
Increase in loans		-	-	(4,835)
Payments of guarantee deposits		(17,802)	(16,239)	(17,861)
Payments of long-term deposits in MSA Escrow Fund		(68,897)	(62,845)	(61,325)
Decrease (increase) in other financial assets		10,000	9,122	(360,000)
Acquisition of redeemable convertible preferred shares		-	-	(26,000)
Net cash used in investing activities		(91,548)	(83,506)	(585,316)
Cash flows from financing activities				
		34		
Dividends paid		(428,284)	(390,663)	(428,056)
Increase in deposits received		1,764	1,609	1,860
Decrease in deposits received		(2,274)	(2,075)	(3,464)
Net cash used in financing activities		(428,794)	(391,129)	(429,660)
Effect of exchange rate fluctuation on cash held		(171)	(155)	19
Net decrease in cash and cash equivalents		22,914	20,902	20,663
Cash and cash equivalents at January 1		444,376	405,341	321,562
Cash and cash equivalents at September 30		₩ 467,290	\$ 426,243	₩ 342,225

See accompanying notes to the separate interim financial statements.

KT&G CORPORATION
Notes to the Separate Interim Financial Statements
(Unaudited)

For the nine-month periods ended September 30, 2016 and 2015

1. Organization and Description of Business

KT&G Corporation (the "Company"), which is engaged in manufacturing and selling tobaccos, 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 Act of Korea. The Korean government sold 28,650,000 shares of the Company to the public during 1999 and the Company listed its shares on the Korea Exchange (formerly, 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 and Ginseng Corporation.

As of September 30, 2016, the Company has three manufacturing plants, including the Shintanjin plant, and 14 local headquarters and 123 branches for the sale of tobacco throughout the country. Also, the Company has the Gimcheon plant for fabrication of leaf tobacco and the Cheonan printing plant for the manufacturing of packaging. The head office of the Company is located at 71, Beotkkot-gil, Daedeok-gu, Daejeon.

Pursuant to the Korean government's privatization program and management reorganization plan, on December 28, 1998, the shareholders 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, Korea Ginseng Corporation.

On October 17, 2002 and October 31, 2001, the Company listed 35,816,658 and 45,400,000 Global Depositary Receipts ("GDR") (each GDR representing the right to receive one-half share of an ordinary share of the Company), respectively, on the Luxembourg Stock Exchange pursuant to the Korean government's privatization program. Also, on June 25, 2009, the market of the Company's GDR was changed from the BdL market to the Euro MTF in the Luxembourg Stock Exchange.

The ownership of the Company's issued ordinary shares as of September 30, 2016 is held as follows:

Shareholder	Number of shares	Percentage of ownership
National Pension Service	11,793,134	8.59%
Industrial Bank of Korea	9,510,485	6.93%
Employee Share Ownership Association	2,818,577	2.05%
Treasury shares	11,148,827	8.12%
Others	102,021,474	74.31%
	137,292,497	100.00%

KT&G CORPORATION
Notes to the Separate Interim Financial Statements
(Unaudited)

For the nine-month periods ended September 30, 2016 and 2015

2. Basis of Preparation

(a) Statement of Compliance

The separate interim financial statements have been prepared in accordance with Korean International Financial Reporting Standards ("K-IFRS"). These separate interim financial statements were prepared in accordance with K-IFRS No. 1034 *Interim Financial Reporting* as part of the period covered by the Company's K-IFRS annual separate financial statements.

These separate interim financial statements are separate financial statements prepared in accordance with K-IFRS No.1027 *Separate Financial Statements* presented by a parent, an investor in an associate or a venture in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

The separate interim financial statements were authorized for issue by the Board of Directors on October 27, 2016.

(b) Basis of Measurement

The separate interim financial statements have been prepared on the historical cost basis, except for the following material items in the separate interim statements of financial position:

- Derivative financial instruments measured at fair value
- Available-for-sale financial assets measured at fair value
- Liabilities for defined benefit plans recognized at the net of the total present value of defined benefit obligations less the fair value of plan assets

(c) Functional and Presentation Currency

These separate interim financial statements are presented in Korean won, which is the Company's functional currency and the currency of the primary economic environment in which the Company operates.

(d) Use of Estimates and Judgments

The preparation of the separate interim financial statements in conformity with K-IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

In preparing these separate interim financial statements, the significant judgments made by management in applying the Company's accounting policies and the key sources of estimation uncertainty were the same as those that applied to the financial statements as of and for the year ended December 31, 2015.

KT&G CORPORATION
Notes to the Separate Interim Financial Statements
(Unaudited)

For the nine-month periods ended September 30, 2016 and 2015

3. Significant Accounting Policies

The significant accounting policies applied by the Company in preparation of its separate interim financial statements are included below. The accounting policies set out below have been applied consistently to all periods presented in these separate interim financial statements.

(a) Subsidiaries and Associates in the Separate Financial Statements

These separate interim financial statements are prepared and presented in accordance with K-IFRS No.1027. The Company applied the cost method to investments in subsidiaries, associates and joint ventures in accordance with K-IFRS No. 1027. Dividends from a subsidiaries, associates and joint ventures are recognized in profit or loss when the right to receive the dividend is established.

(b) Property, Plant and Equipment

All property, plant and equipment are stated at historical cost less depreciation and accumulated impairment loss. Historical cost includes expenditures directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. All other repairs and maintenance are charged to the statement of comprehensive income during the financial period in which they are incurred.

Property, plant and equipment, except for land and other tangible fixed assets, are depreciated on a straight-line basis over estimated useful lives that appropriately reflect the pattern in which the asset's future economic benefits are expected to be consumed.

The estimated useful lives of the Company's assets are as follows:

	Useful lives (years)		Useful lives (years)
Buildings	10 ~ 60	Vehicles	4
Structures	10 ~ 40	Tools	4
Machinery	10 ~ 12	Furniture and fixtures	4

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized in other income and expense in the statement of comprehensive income.

KT&G CORPORATION
Notes to the Separate Interim Financial Statements
(Unaudited)

For the nine-month periods ended September 30, 2016 and 2015

3. Significant Accounting Policies, Continued

(c) Borrowing Costs

The Company capitalizes borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Other borrowing costs are recognized in expense as incurred. A qualifying asset is an asset that requires a substantial period of time to get ready for its intended use or sale. Financial assets and inventories that are manufactured or otherwise produced over a short period of time are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

To the extent that the Company borrows funds specifically for the purpose of obtaining a qualifying asset, the Company determines the amount of borrowing costs eligible for capitalization as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. The Company immediately recognizes other borrowing costs as an expense. To the extent that the Company borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the Company determines the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the borrowings of the Company that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that the Company capitalizes during a period does not exceed the amount of borrowing costs incurred during that period.

(d) Government Grants

Government grants are not recognized unless there is reasonable assurance that the Company will comply with the grant's conditions and that the grant will be received. Government grants which are intended to compensate the Company for expenses incurred are recognized as other income in profit or loss over the periods in which the Company recognizes the related costs as expenses.

(e) Intangible Assets

Intangible assets are measured initially at cost and, subsequently, are carried at cost less accumulated amortization and accumulated impairment losses. Intangible assets consist of industrial property rights, facility usage rights and intangible assets under development. Intangible assets are amortized on a straight-line basis over the estimated useful lives of intangible assets from the date that they are available for use. The residual value of intangible assets is assumed to be zero. However, as there are no foreseeable limits to the periods over which some of industrial property rights and facility usage rights are expected to be available for use, these intangible assets are regarded as having indefinite useful lives and not amortized.

The estimated useful lives are as follows:

	Useful lives (years)
Industrial property rights	10 ~ 20 or indefinite
Facility usage rights	indefinite

Amortization periods and amortization methods for intangible assets with finite useful lives are reviewed at the end of each reporting period. The useful lives of intangible assets that are not being amortized are reviewed at the end of each reporting period to determine whether events and circumstances continue to support indefinite useful life assessment for those assets. The change is accounted for as a change in an accounting estimate.

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3. Significant Accounting Policies, Continued

(f) Investment Property

Property held for the purpose of earning rentals or benefiting from capital appreciation is classified as investment property. Investment property is initially measured at its cost. Transaction costs are included in the initial measurement. Subsequently, investment property is carried at depreciated cost less any accumulated impairment losses.

Subsequent costs are recognized in the carrying amount of investment property at cost or, if appropriate, as separate items if it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing are recognized in profit or loss as incurred.

Investment property except for land, are depreciated on a straight-line basis over 10 ~ 60 years as estimated useful lives.

Depreciation methods, useful lives and residual values are reviewed at the end of each reporting period and adjusted, if appropriate. The change is accounted for as a change in an accounting estimate.

(g) Non-current Assets Held for Sale

Non-current assets, or disposal groups comprising assets and liabilities, that are expected to be recovered primarily through sale rather than through continuing use, are classified as held for sale. In order to be classified as held for sale, the asset (or disposal group) must be available for immediate sale in its present condition and its sale must be highly probable. The assets or disposal group that are classified as non-current assets held for sale are measured at the lower of their carrying amount and fair value less cost to sell.

The Company recognizes an impairment loss for any initial or subsequent write-down of an asset (or disposal group) to fair value less costs to sell, and a gain for any subsequent increase in fair value less costs to sell, up to the cumulative impairment loss previously recognized in accordance with K-IFRS No. 1036 *Impairment of Assets*.

A non-current asset that is classified as held for sale or part of a disposal group classified as held for sale is not depreciated (or amortized).

(h) Inventories

Inventories are measured at the lower of cost and net realizable value. The cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

The cost of inventories is determined by the weighted-average method for finished goods, by-products, work-in-progress and tobacco leaf in raw materials, by the moving-average method for raw materials and supplies; and by the specific identification method for all other inventories.

KT&G CORPORATION
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3. Significant Accounting Policies, Continued

(h) Inventories, Continued

When inventories are sold, the carrying amount of those inventories is recognized as an expense in the period in which the related revenue is recognized. The amount of any write-down of inventories to net realizable value and all losses of inventories are recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value, is recognized as a reduction in the amount of inventories and recognized as an expense in the period in which the reversal occurs.

Tobacco leaf inventories which have an operating cycle that exceeds 12 months are classified as current assets, consistent with recognized industry practice. The estimated amounts of inventories in current assets which are not expected to be realized within 12 months are ₩266,683 million and ₩310,043 million, respectively, as of September 30, 2016 and December 31, 2015.

(i) Impairment of Non-financial Assets

The carrying amounts of the Company's non-financial assets, other than inventories, deferred tax assets, assets arising from employee benefits and non-current assets held for sale, are reviewed at the end of the reporting period to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. Goodwill and intangible assets that have indefinite useful lives or that are not yet available for use, irrespective of whether there is any indication of impairment, are tested for impairment annually by comparing their recoverable amount to their carrying amount.

The Company estimates the recoverable amount of an individual asset. If it is impossible to measure the individual recoverable amount of an asset, then the Company estimates the recoverable amount of cash-generating unit ("CGU"). A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. The recoverable amount of an asset or CGU is the greater of its value in use and its fair value less costs to sell. The value in use is estimated by applying a pre-tax discount rate that reflect current market assessments of the time value of money and the risks specific to the asset or CGU for which estimated future cash flows have not been adjusted, to the estimated future cash flows expected to be generated by the asset or CGU.

An impairment loss is recognized if the carrying amount of an asset or a CGU exceeds its recoverable amount. Impairment losses are recognized in profit or loss.

(j) Non-derivative Financial Assets

The Company recognizes and measures non-derivative financial assets by the following four categories: financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables and available-for-sale financial assets. The Company recognizes financial assets in the statement of financial position when the Company becomes a party to the contractual provisions of the instrument.

Upon initial recognition, non-derivative financial assets are measured at their fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the asset's acquisition or issuance.

KT&G CORPORATION
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3. Significant Accounting Policies, Continued

(j) Non-derivative Financial Assets, Continued

(i) Financial assets at fair value through profit or loss

A financial asset is classified as financial assets at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition, transaction costs are recognized in profit or loss when incurred. Financial assets at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss.

(ii) Held-to-maturity investments

A non-derivative financial asset with a fixed or determinable payment and fixed maturity, for which the Company has the positive intention and ability to hold to maturity, are classified as held-to-maturity investments. Subsequent to initial recognition, held-to-maturity investments are measured at amortized cost using the effective interest method.

(iii) Loans and receivables

Loans and receivables are financial assets with fixed or determinable payments that are not quoted in an active market. Subsequent to initial recognition, loans and receivables are measured at amortized cost using the effective interest method except for loans and receivables of which the effect of discounting is immaterial.

(iv) Available-for-sale financial assets

Available-for-sale financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified as financial assets at fair value through profit or loss, held-to-maturity investments or loans and receivables. Subsequent to initial recognition, they are measured at fair value, which changes in fair value, net of any tax effect, recorded in other comprehensive income in equity. Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments are measured at cost.

(v) De-recognition of financial assets

The Company derecognizes a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Company is recognized as a separate asset or liability.

If the Company retains substantially all the risks and rewards of ownership of the transferred financial assets, the Company continues to recognize the transferred financial assets and recognizes financial liabilities for the consideration received.

KT&G CORPORATION
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For the nine-month periods ended September 30, 2016 and 2015

3. Significant Accounting Policies, Continued

(j) Non-derivative Financial Assets, Continued

- (vi) Offsetting between financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount is presented in the statement of financial position only when the Company currently has a legally enforceable right to offset the recognized amounts, and there is the intention to settle on a net basis or to realize the asset and settle the liability simultaneously.

(k) Derivative Financial Instruments

Derivatives are initially recognized at fair value. Subsequent to initial recognition, derivatives are measured at fair value, and changes therein are recognized immediately in profit or loss.

Embedded derivatives are separated from the host contract and accounted for separately only if the following criteria have been met:

- the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative and
- the hybrid instrument is not measured at fair value with changes in fair value recognized in profit or loss.

Changes in the fair value of separable embedded derivatives are recognized immediately in profit or loss.

(l) Impairment of Financial Assets

A financial asset not carried at fair value through profit or loss is assessed at each reporting date to determine whether there is objective evidence that it is impaired. A financial asset is impaired if objective evidence indicates that a loss event has occurred after the initial recognition of the asset, and that the loss event had a negative effect on the estimated future cash flows of that asset that can be estimated reliably. However, losses expected as a result of future events, regardless of likelihood, are not recognized.

If financial assets have objective evidence that they are impaired, impairment losses should be measured and recognized.

- (i) Financial assets measured at amortized cost

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of its estimated future cash flows discounted at the asset's original effective interest rate. If it is not practicable to obtain the instrument's estimated future cash flows, impairment losses would be measured by using prices from any observable current market transactions. The Company can recognize impairment losses directly or establish a provision to cover impairment losses. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed either directly or by adjusting an allowance account.

KT&G CORPORATION
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For the nine-month periods ended September 30, 2016 and 2015

3. Significant Accounting Policies, Continued

(l) Impairment of Financial Assets, Continued

- (ii) Financial assets carried at cost

If there is objective evidence that an impairment loss has occurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses are not reversed.

- (iii) Available-for-sale financial assets

When a decline in the fair value of an available-for-sale financial asset has been recognized in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized in other comprehensive income is reclassified from other comprehensive income to profit or loss as a reclassification adjustment even though the financial asset has not been derecognized. Impairment losses recognized in profit or loss for an investment in an equity instrument classified as available-for-sale are not reversed through profit or loss. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in profit or loss, the impairment loss is reversed, with the amount of the reversal recognized in profit or loss. For an investment in an equity security, objective evidence of impairment includes a significant or prolonged decline in its fair value below its cost. The Company considers a decline of 20% to be significant and a period of nine months to be prolonged.

(m) Cash and Cash Equivalents

Cash and cash equivalents comprise cash balances and call deposits with maturities of three months or less from the acquisition date that are subject to an insignificant risk of changes in their fair value, and are used by the Company in the management of its short-term commitments. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares when it has a short maturity with a specified redemption date.

(n) Non-derivative Financial Liabilities

The Company classifies non-derivative financial liabilities into financial liabilities at fair value through profit or loss, financial guarantee liabilities and other financial liabilities in accordance with the substance of the contractual arrangement and the definitions of financial liabilities. The Company recognizes financial liabilities in the statement of financial position when the Company becomes a party to the contractual provisions of the financial liability.

- (i) Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss include financial liabilities held for trading or designated as such upon initial recognition. Subsequent to initial recognition, financial liabilities at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss. Upon initial recognition, transaction costs that are directly attributable to the acquisition are recognized in profit or loss as incurred.

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3. Significant Accounting Policies, Continued

(n) Non-derivative Financial Liabilities, Continued

(ii) Financial guarantee liabilities

Financial guarantee liability is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified term of a debt instrument. Upon initial recognition, financial guarantee liabilities are measured at their fair value plus, transaction costs that are directly attributable to the acquisition or issue of the financial guarantee liability.

After initial recognition, an issuer of such a contract measures it at the higher of the amount determined in accordance with K-IFRS No. 1037 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognized less, when appropriate, cumulative amortisation recognized in accordance with K-IFRS No. 1018 *Revenue*.

(iii) Other financial liabilities

Non-derivative financial liabilities other than financial liabilities at fair value through profit or loss or financial guarantee liabilities are classified as other financial liabilities. At the date of initial recognition, other financial liabilities are measured at fair value minus transaction costs that are directly attributable to the acquisition. Subsequent to initial recognition, other financial liabilities are measured at amortized cost using the effective interest method.

The Company derecognizes a financial liability from the statement of financial position when it is extinguished (i.e. when the obligation specified in the contract is discharged, cancelled or expires).

(o) Employee Benefits

(i) Short-term employee benefits

Short-term employee benefits are employee benefits that are due to be settled within 12 months after the end of the period in which the employees render the related service. When an employee has rendered service to the Company during an accounting period, the Company recognizes the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service.

(ii) Retirement benefits: defined contribution plans

When an employee has rendered service to the Company during a period, the Company recognizes the contribution payable to a defined contribution plan in exchange for that service as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, the Company recognizes that excess as an asset (prepaid expense) to the extent that the prepayment will lead to a reduction in future payments or a cash refund.

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3. Significant Accounting Policies, Continued

(o) Employee Benefits, Continued

(iii) Retirement benefits: defined benefit plans

The calculation of defined benefit obligations is performed annually by a qualified actuary using the projected unit credit method. When the calculation results in a potential asset for the Company, the recognized asset is limited to the present value of economic benefits available in the form of any future refunds from the plan or reductions in future contributions to the plan. To calculate the present value of economic benefits, consideration is given to any applicable minimum funding requirements.

Remeasurements of the net defined benefit liability, which comprise actuarial gains and losses, the return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognized immediately in other comprehensive income. The Company determines the net interest expense (income) on the net defined benefit liability (asset) for the year by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then-net defined benefit liability (asset), taking into account any changes in the net defined benefit liability (asset) during the period as a result of contributions and benefit payments. Net interest expense and other expenses related to defined benefit plans are recognized in profit or loss.

(iv) Termination benefits

Termination benefits are expensed at the earlier of when the Company can no longer withdraw the offer of those benefits and when the Company recognizes costs for a restructuring. If benefits are not expected to be settled wholly within 12 months of the end of the reporting period, then they are discounted.

(p) Provisions

Provisions are recognized when the Company has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

The risks and uncertainties that inevitably surround many events and circumstances are taken into account in reaching the best estimate of a provision. Where the effect of the time value of money is material, provisions are determined at the present value of the expected future cash flows.

Where some or all of the expenditures required to settle a provision are expected to be reimbursed by another party, the reimbursement shall be recognized when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset.

Provisions are reviewed at the end of each reporting period and adjusted to reflect the current best estimates. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision is reversed.

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3. Significant Accounting Policies, Continued

(q) Equity Capital

Ordinary shares are classified as equity. Incremental costs directly attributable to the issuance of ordinary shares and share options are recognized as a deduction from equity, net of any tax effects.

When the Company repurchases its share capital, the amount of the consideration paid is recognized as a deduction from equity and classified as treasury shares. The profits or losses from the purchase, disposal, reissue, or retirement of treasury shares are not recognized as current profit or loss. If the Company acquires and retains treasury shares, the consideration paid or received is directly recognized in equity.

(r) Revenue Recognition

The Company's revenue categories consist of goods sold, services and other income.

Revenue from sales of goods is measured at the fair value of the consideration received or receivable, net of tobacco excise and other taxes, trade discounts and volume rebates. Revenue from the sale of goods is recognized when the Company has transferred to the buyer the significant risks and rewards of ownership of the goods, the Company retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Company and the costs incurred or to be incurred in respect of the transaction can be measured reliably. Tobacco excise and other taxes deducted from revenue for the nine-month periods ended September 30, 2016 and 2015 were ₩4,656,466 million and ₩3,706,928 million, respectively.

Revenue from sales of real estate where the Company transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses is recognized by reference to the stage of completion using the percentage of completion method, according to the Q&A of Korea Accounting Institute, called 2011-I-KQA, when it is probable that they will result in revenue and can be measured reliably. The stage of completion is determined as the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs.

Revenue from rendering of services is recognized by reference to the stage of completion of the transaction at the end of the reporting period when the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Company, the stage of completion of the transaction at the end of the reporting period can be measured reliably and the costs incurred for the transaction and the costs to complete the transaction can be measured reliably. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue is recognized only to the extent of the expenses recognized that are recoverable.

Rental income from investment property, net of lease incentives granted, is recognized in profit or loss on a straight-line basis over the term of the lease.

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3. Significant Accounting Policies, Continued

(s) Finance Income and Finance Costs

Finance income comprises interest income on funds invested (including available-for-sale financial assets), dividend income and interest income on long-term deposits in MSA Escrow Fund. Interest income is recognized as it accrues in profit or loss, using the effective interest method. Dividend income is recognized in profit or loss on the date that the Company's right to receive payment is established.

Finance costs is interest expense on unwinding of the discount on trade and other payables which is recognized in profit or loss using the effective interest method.

(t) Income Taxes

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

(i) Current tax

Current tax is the expected tax payable or receivable on the taxable profit or loss for the year, using tax rates enacted or substantively enacted at the end of the reporting period and any adjustment to tax payable in respect of previous years. The taxable profit is different from the accounting profit for the year since the taxable profit is calculated excluding the temporary differences, which will be taxable or deductible in determining taxable profit (tax loss) of future periods, and non-taxable or non-deductible items from the accounting profit.

(ii) Deferred tax

The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities. The Company recognizes a deferred tax asset for all deductible temporary differences to the extent that it is probable that the temporary difference will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilized.

The carrying amount of a deferred tax asset is reviewed at the end of each reporting period and reduces the carrying amount to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilized.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period to recover or settle the carrying amount of its assets and liabilities.

Deferred tax assets and liabilities are offset only if there is a legally enforceable right to offset the related current tax liabilities and assets, and they relate to income taxes levied by the same tax authority and they intend to settle current tax liabilities and assets on a net basis

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3. Significant Accounting Policies, Continued

(u) Foreign Currencies

Transactions in foreign currencies are translated to the respective functional currencies of the Company at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated to the functional currency using the reporting date's exchange rate. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated to the functional currency at the exchange rate at the date that the fair value was determined.

Foreign currency differences arising on retranslation are recognized in profit or loss, except for differences arising on the retranslation of available-for-sale equity instruments, a financial liability designated as a hedge of the net investment in a foreign operation, or qualifying cash flow hedges, which are recognized in other comprehensive income. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

(v) Earnings per Share

The Company presents basic and diluted earnings per share ("EPS") data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period, adjusted for own shares held. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding, adjusted for own shares held, for the effects of all dilutive potential ordinary shares.

(w) Operating Segment

An operating segment is a component of the Company that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Company's other components. All operating segments' operating results are reviewed regularly by the Company's chief executive officer to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available.

Operating segment disclosures are included in the consolidated financial statements in accordance with K-IFRS No. 1108 *Operating Segments*.

4. Basis of Translating Financial Statements

The separate interim financial statements are expressed in Korean won and have been translated into U.S. dollars at the rate of ₩1,096.30 to \$1, the basic exchange rate on September 30, 2016 posted by Seoul Money Brokerage Services, solely for the convenience of the reader. 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.

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5. Property, Plant and Equipment

- (a) Details of property, plant and equipment as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016			December 31 2015		
	Cost	Accumulated depreciation	Carrying amount	Cost	Accumulated depreciation	Carrying amount
Land	₩ 471,857	-	471,857	467,590	-	467,590
Buildings	697,397	(329,828)	367,569	696,569	(311,151)	385,418
Structures	45,178	(30,555)	14,623	44,962	(29,061)	15,901
Machinery	1,019,780	(806,343)	213,437	991,848	(775,864)	215,984
Vehicles	2,295	(1,898)	397	2,211	(1,855)	356
Tools	38,239	(33,561)	4,678	37,753	(32,199)	5,554
Furniture and fixtures	178,581	(148,164)	30,417	169,422	(135,913)	33,509
Others	1,656	-	1,656	1,366	-	1,366
Construction-in-progress	85,866	-	85,866	183,954	-	183,954
	₩ 2,540,849	(1,350,349)	1,190,500	2,595,675	(1,286,043)	1,309,632

- (b) Changes in property, plant and equipment for the nine-month period ended September 30, 2016 were as follows:

<i>In millions of won</i>	January 1 2016	Acquisition	Disposal	Depreciation	Transfer of construction- in-progress	Other changes	September 30 2016
Land	₩ 467,590	40	(975)	-	52,028	(46,826)	471,857
Buildings	385,418	874	(1,145)	(20,210)	80,135	(77,503)	367,569
Structures	15,901	173	(7)	(1,619)	194	(19)	14,623
Machinery	215,984	1,176	(248)	(36,263)	32,788	-	213,437
Vehicles	356	331	(166)	(133)	-	9	397
Tools	5,554	930	(13)	(1,785)	-	(8)	4,678
Furniture and fixtures	33,509	8,407	(4,919)	(12,385)	5,805	-	30,417
Others	1,366	-	-	-	290	-	1,656
Construction-in-progress	183,954	73,188	-	-	(171,240)	(36)	85,866
	₩ 1,309,632	85,119	(7,473)	(72,395)	-	(124,383)	1,190,500

For the nine-month period ended September 30, 2016, the Company received ₩289 million of government grant related with acquisition of buildings and furniture and fixtures.

For the nine-month period ended September 30, 2016, land, buildings and structures with a carrying amount of ₩124,347 million were transferred to investment property and construction-in-progress with a carrying amount of ₩36 million were transferred to intangible assets.

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5. Property, Plant and Equipment, Continued

(c) Changes in property, plant and equipment for the year ended December 31, 2015 were as follows:

<i>In millions of won</i>	January 1 2015	Acquisition	Disposal	Depreciation	Transfer of construction- in-progress	Other changes	December 31 2015
Land	₩ 457,890	7,158	(773)	-	5,293	(1,978)	467,590
Buildings	404,503	1,238	(398)	(26,812)	9,124	(2,237)	385,418
Structures	17,150	836	(41)	(2,159)	174	(59)	15,901
Machinery	236,848	4,649	(411)	(50,716)	25,614	-	215,984
Vehicles	271	263	(14)	(193)	29	-	356
Tools	4,447	3,005	(144)	(2,101)	347	-	5,554
Furniture and fixtures	35,447	15,276	(6)	(17,236)	28	-	33,509
Others	1,312	54	-	-	-	-	1,366
Construction-in-progress	121,792	102,771	-	-	(40,609)	-	183,954
	₩ 1,279,660	135,250	(1,787)	(99,217)	-	(4,274)	1,309,632

For the year ended December 31, 2015, land and buildings with a carrying amount of ₩2,732 million were transferred to investment property and land, buildings and structures with a carrying amount of ₩1,542 million were transferred to non-current assets held for sale.

6. Intangible Assets

(a) Details of intangible assets as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016			December 31 2015		
	Cost	Accumulated amortization	Carrying amount	Cost	Accumulated amortization	Carrying amount
Industrial property rights	₩ 7,442	(5,549)	1,893	6,997	(5,535)	1,462
Facility usage rights	24,407	(1,708)	22,699	19,180	(1,708)	17,472
Intangible assets under development	3,560	-	3,560	3,560	-	3,560
	₩ 35,409	(7,257)	28,152	29,737	(7,243)	22,494

(b) Changes in intangible assets for the nine-month period ended September 30, 2016 were as follows:

<i>In millions of won</i>	January 1 2016	Acquisition	Disposal	Transfer from property, plant and equipment	Amortization	September 30 2016
Industrial property rights	₩ 1,462	446	-	-	(15)	1,893
Facility usage rights	17,472	5,380	(189)	36	-	22,699
Intangible assets under development	3,560	-	-	-	-	3,560
	₩ 22,494	5,826	(189)	36	(15)	28,152

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6. Intangible Assets, Continued

(c) Changes in intangible assets for the year ended December 31, 2015 were as follows:

<i>In millions of won</i>		January 1 2015	Acquisition	Disposal	Amortization	December 31 2015
Industrial property rights	₩	1,567	23	(104)	(24)	1,462
Facility usage rights		15,043	3,195	(766)	-	17,472
Intangible assets under development		3,026	534	-	-	3,560
	₩	19,636	3,752	(870)	(24)	22,494

(d) Expenditures not capitalized for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Cost of sales	₩	71	267	82	186
Selling, general and administrative expenses		2,497	7,178	2,461	7,945
	₩	2,568	7,445	2,543	8,131

7. Investment Property

(a) Details of investment property as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>		September 30 2016			December 31 2015		
		Cost	Accumulated depreciation	Carrying amount	Cost	Accumulated depreciation	Carrying amount
Land	₩	69,892	-	69,892	23,066	-	23,066
Buildings		251,001	(65,994)	185,007	172,757	(59,022)	113,735
	₩	320,893	(65,994)	254,899	195,823	(59,022)	136,801

(b) Changes in investment property for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won</i>		2016			2015		
		Land	Buildings	Total	Land	Buildings	Total
Beginning balance	₩	23,066	113,735	136,801	22,236	117,905	140,141
Acquisition		-	-	-	-	64	64
Depreciation		-	(6,249)	(6,249)	-	(6,136)	(6,136)
Transfer from property, plant and equipment		46,826	77,521	124,347	830	1,902	2,732
Ending balance	₩	69,892	185,007	254,899	23,066	113,735	136,801

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7. Investment Property, Continued

- (c) The amounts recognized in profit or loss from investment property for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016		2015	
	Three-month	Nine-month	Three-month	Nine-month
Rental income	₩ 10,020	27,880	8,417	25,624
Direct operating expense	(2,537)	(6,249)	(1,535)	(4,601)
	₩ 7,483	21,631	6,882	21,023

- (d) The carrying amount and the fair value of investment property as of September 30, 2016 and December 31, 2015 were as follows:

<i>In millions of won</i>	September 30 2016		December 31 2015	
	Fair value	Carrying amount	Fair value	Carrying amount
Land	₩ 532,420	69,892	406,600	23,066
Buildings	227,030	185,007	171,979	113,735
	₩ 759,450	254,899	578,579	136,801

The fair value of investment property was determined based on the yield capitalization method by external, independent valuers. The fair value measurement for all of the investment properties has been categorized as a level 3 fair value based on the inputs to the valuation techniques used.

8. Investments in Associates

Investments in associates as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	Company	Location	Principal operation	September 30 2016		December 31 2015	
				Percentage of ownership	Carrying amount	Percentage of ownership	Carrying amount
	Lite Pharm Tech, Inc.	Korea	Manufacturing medical supplies	20.24%	₩ 1,830	20.24%	₩ 1,830
	KVG REIT 1 Co., Ltd.	Korea	Renting real estate	29.67%	7,300	29.67%	7,300
	KOCREF REIT 17 Co., Ltd.	Korea	Renting real estate	-	-	22.06%	7,000
	JR REIT V Co., Ltd.	Korea	Renting real estate	34.63%	5,600	34.63%	5,600
	JR REIT VIII Co., Ltd.	Korea	Renting real estate	21.74%	10,000	21.74%	10,000
	LSK Global Pharma Services Co., Ltd.	Korea	Researching and developing medicine	23.15%	-	23.15%	-
	JR REIT X Co., Ltd.	Korea	Renting real estate	28.79%	9,500	28.79%	9,500
	JR REIT XIII Co., Ltd.	Korea	Renting real estate	27.03%	5,000	27.03%	5,000
					₩39,230		₩46,230

For the nine-month period ended September 30, 2016, the Company recognized ₩6,095 million of gain on disposal of investments in associates as KOCREF REIT 17 Co., Ltd. was liquidated.

In 2015, the Company's ownership in Lite Pharm Tech, Inc. has decreased to 20.24% due to their paid-in capital increase.

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9. Investments in Subsidiaries

Investments in subsidiaries as of September 30, 2016 and December 31, 2015 are summarized as follows:

In millions of won

Company	Location	Principal operation	September 30 2016		December 31 2015	
			Percentage of ownership	Carrying amount	Percentage of ownership	Carrying amount
Korea Ginseng Corporation	Korea	Manufacturing and selling ginseng	100.00%	₩ 672,048	100.00%	₩ 672,048
Yungjin Pharm. Ind. Co., Ltd.	Korea	Manufacturing and selling pharmaceutical	53.00%	66,355	53.00%	66,355
Tae-a Industry Co., Ltd.	Korea	Manufacturing tobacco materials	100.00%	15,698	100.00%	15,698
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	Manufacturing and selling tobaccos	99.99%	30,049	99.99%	30,049
Korea Tabacos do Brasil Ltda.	Brazil	Processing leaf tobaccos	99.99%	2,891	99.99%	2,891
KT&G Pars	Iran	Manufacturing and selling tobaccos	99.99%	-	99.99%	-
KT&G Rus L.L.C.	Russia	Manufacturing and selling tobaccos	100.00%	110,297	100.00%	110,297
KGC Life & Gin Co., Ltd.	Korea	Selling ginseng door-to-door	100.00%	44,100	100.00%	44,100
Global Trading, Inc.	USA	Selling tobaccos	100.00%	4,913	100.00%	4,913
Cosmococ Co., Ltd	Korea	Manufacturing and selling cosmetics	98.49%	98,094	97.73%	70,676
Renzoluc Pte., Ltd. (*)	Singapore	Manufacturing and selling tobaccos	100.00%	-	100.00%	-
KT&G Life Sciences Corporation	Korea	Researching and developing medicine	31.19%	14,287	73.94%	14,287
KGC Yebon Corporation	Korea	Manufacturing and selling medical herbs	100.00%	49,828	100.00%	49,828
K-Q HongKong I, Limited (*)	HongKong	Manufacturing and selling ginseng	100.00%	17,761	100.00%	17,761
PT KT&G Indonesia	Indonesia	Manufacturing and selling tobaccos	99.99%	-	99.99%	-
K&I HK Co., Ltd.	HongKong	Selling cosmetics	100.00%	11	100.00%	11
K&I China Co., Ltd.	China	Selling cosmetics	100.00%	5,532	100.00%	5,532
SangSang Stay, Inc.	Korea	Hotel	100.00%	20,000	100.00%	20,000
KT&G Global Rus L.L.C.	Russia	Selling tobaccos	100.00%	1,497	-	-
				₩1,153,361		₩1,124,446

(*) The Company's percentage of ownership, shown above, excludes preferred shares. As of September 30, 2016, the Company's percentage of ownership would be 68.91% and 50.00%, respectively, if preferred shares are included.

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9. Investments in Subsidiaries, Continued

For the nine-month period ended September 30, 2016, the ownership interest in KT&G Life Sciences Corporation has decreased to 31.19% from 73.94% as a result of the conversion of redeemable convertible preferred shares.

For the nine-month period ended September 30, 2016, the Company acquired ₩27,418 million of additional shares of Cosmococ Co., Ltd. as a result of the exercise of conversion options embedded in its redeemable convertible preferred shares, increasing its ownership from 97.73% to 98.49%.

For the nine-month period ended September 30, 2016, the Company established KT&G Global Rus L.L.C.

For the year ended December 31, 2015, the Company acquired additional shares of Cosmococ Co., Ltd. for ₩49,775 million, increasing its ownership from 60.00% to 97.73%.

For the year ended December 31, 2015, the Company made an additional investment of ₩2,356 million and ₩5,096 million in Korea Tobacos do Brasil Ltda. and K&I China Co., Ltd, respectively, and established SangSang Stay, Inc.

For the year ended December 31, 2015, the Company recognized ₩34,601 million of impairment losses on investments in Renzoluc Pte., Ltd., KT&G Life Sciences Corporation and PT KT&G Indonesia since the carrying amounts exceeded their recoverable amounts.

10. Available-for-sale Financial Assets

- (a) Changes in available-for-sale financial assets for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won</i>		2016	2015
Beginning balance	₩	340,149	304,438
Acquisitions		15,000	63,190
Net changes in fair value		3,035	1,744
Disposals or exercise of conversion options		-	(29,223)
Ending balance	₩	358,184	340,149
Statement of financial position:			
Current	₩	1,500	-
Non-current		356,684	340,149
	₩	358,184	340,149

In 2015, the Company acquired ₩28,990 million of ordinary shares of U&I Corporation by exercising conversion options embedded in their convertible bonds and redeemable convertible preferred shares. The Company recognized ₩24,990 million of difference between the fair value of ordinary shares acquired and the carrying amount of bonds and preferred shares converted as gain on sale of available-for-sale financial assets for the year ended December 31, 2015.

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10. Available-for-sale Financial Assets, Continued

(b) Available-for-sale financial assets as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Available-for-sale debt instruments:		
Corporate bonds	₩ 1,500	1,500
Available-for-sale equity instruments:		
Listed		
– Shinhan Financial Group Co., Ltd.	160,935	158,530
– Oscotech, Inc.	5,053	3,696
– Rexahn Pharmaceuticals, Inc.	1,471	2,696
– U&I Corporation	22,081	22,564
	189,540	187,486
Unlisted	167,144	151,163
Total available-for-sale equity instruments	356,684	338,649
Total available-for-sale financial assets	₩ 358,184	340,149

The fair value of listed available-for-sale equity instruments is principally based on quoted prices in an active market.

As of September 30, 2016 and December 31, 2015, ₩52,555 million and ₩37,555 million of available-for-sale financial assets, respectively, that do not have a market price in an active market and whose fair value cannot be reliably measured or is similar to their carrying amount are measured at cost.

11. Long-term Deposits in MSA Escrow Fund

Long-term deposits in MSA Escrow Fund as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
MMF	₩ 260,925	43,309
Treasury note	183,771	360,657
	₩ 444,696	403,966

As discussed in note 33 to the separate interim financial statements, long-term deposits in MSA Escrow Fund are deposited to the United States government related to the export of tobacco to the United States. For the nine-month periods ended September 30, 2016 and 2015, ₩68,897 million and ₩61,325 million were paid into long-term deposits in MSA Escrow Fund, respectively.

Long-term deposits in MSA Escrow Fund are invested in demand deposits of financial institutions or government and public bonds. Interest income on long-term deposits in MSA Escrow Fund for the nine-month periods ended September 30, 2016 and 2015 are ₩3,554 million and ₩1,796 million, respectively.

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12. Trade and Other Receivables

(a) Trade and other receivables as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016		December 31 2015	
	Current	Non-current	Current	Non-current
Loans to employees	₩ 14,409	43,803	15,767	51,976
Loans	72,997	2,741	69,813	8,204
Other receivables	97,862	3,709	142,130	1,551
Guarantee deposits	23,230	19,746	19,070	16,869
Accrued income	8,054	-	8,912	-
Trade receivables	956,062	-	819,170	-
	₩ 1,172,614	69,999	1,074,862	78,600

(b) Trade and other receivables as of September 30, 2016 and December 31, 2015 have been reported in the separate statements of financial position net of allowances as follows:

<i>In millions of won</i>	September 30 2016		December 31 2015	
	Current	Non-current	Current	Non-current
Gross trade and other receivables	₩ 1,211,608	77,777	1,121,048	78,600
Allowance:				
Loans	(3,864)	(7,778)	(12,447)	-
Other receivables	(9,104)	-	(7,570)	-
Accrued income	(2,118)	-	(2,264)	-
Trade receivables	(23,908)	-	(23,905)	-
	(38,994)	(7,778)	(46,186)	-
Net trade and other receivables	₩ 1,172,614	69,999	1,074,862	78,600

(c) Changes in the allowance account for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won</i>	2016	2015
Beginning balance	₩ 46,186	55,083
Impairment loss	586	2,569
Reversal of impairment loss	-	(11,466)
Ending balance	₩ 46,772	46,186

Impairment loss (reversal of impairment loss) on trade and other receivables is included as part of selling, general and administrative expenses and other expense (income) in the separate statements of comprehensive income.

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12. Trade and Other Receivables, Continued

- (d) The aging schedule of trade and other receivables which were past due but not impaired as of September 30, 2016 and December 31, 2015 is as follows:

<i>In millions of won</i>		September 30 2016	December 31 2015
Within 1 month	₩	57,913	48,107
Between 1 and 2 months		37,918	39,921
Beyond 2 months		232,781	245,788
	₩	328,612	333,816

There is no significant concentration of credit risk with respect to trade and other receivables since trade and other receivables, excluding export trade receivables, are widely dispersed amongst a number of customers. The Company holds pledged assets and guarantees in respect of some of the past due debtor balances.

- (e) Details of trade and other receivables that are measured at amortized cost as of September 30, 2016 and December 31, 2015 were as follows:

<i>In millions of won</i>	Effective interest rate	September 30 2016		Effective interest rate	December 31 2015	
		Current	Non-current		Current	Non-current
Loans to employees	1.83~5.68%	₩ 14,409	43,803	1.89~5.68%	₩ 15,767	51,976
Guarantee deposits	1.83~5.68%	23,230	19,746	1.89~5.68%	19,070	16,869
		₩ 37,639	63,549		₩ 34,837	68,845

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13. Inventories

(a) Inventories as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Finished goods, net of loss on write-down of inventories	₩ 68,613	72,394
Work-in-progress	18,263	15,294
Raw materials	643,383	685,101
Supplies	28,352	25,959
By-products	5,368	5,515
Buildings under construction	7,204	3,618
Sites for lotting-out construction	19,044	25,815
Goods-in-transit	33,827	55,339
	₩ 824,054	889,035

(b) The amount of inventories recognized as an expense for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016		2015	
	Three-month	Nine-month	Three-month	Nine-month
Cost of sales:				
Write-down (reversal of write-down) of inventories	₩ 133	178	(12)	(165)
Loss on retirement of inventories	1,044	1,852	335	638
Other expense:				
Loss on retirement of inventories	16	235	239	356
	₩ 1,193	2,265	562	829

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14. Cash and Cash Equivalents and Other Financial Assets

(a) Cash and cash equivalents as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Cash on hand	₩ 1,792	2,623
Demand deposits	85,498	71,753
Short-term investment assets	380,000	370,000
	₩ 467,290	444,376

(b) Other financial assets as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Time deposits	₩ 100,000	100,000
Money trust	940,000	950,000
Certificates of deposit	30,000	30,000
Derivative financial instruments	-	11,976
	₩ 1,070,000	1,091,976

In 2015, the Company acquired redeemable convertible preferred shares of Cosmococ Co., Ltd. and recognized embedded derivatives as other financial assets separately from the host contract. The Company exercised those conversion options and recognized ₩311 million of gain on conversion of redeemable convertible preferred shares for the nine-month period ended September 30, 2016.

15. Non-current Assets Held for Sale

Changes in non-current assets held for sale for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won</i>	2016	2015
Beginning balance	₩ 1,542	426
Transfer from property, plant and equipment	-	1,542
Disposal	(1,542)	(426)
Ending balance	₩ -	1,542

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16. Pledged Assets

- (a) Investment property pledged as collateral as of September 30, 2016 was as follows:

In millions of won

Asset	Carrying amount	Type	Received amount	Collateralized amount	Leaseholder
Investment property	₩ 66,361	Leasehold deposits received	₩ 8,975	9,225	Metlife Insurance Korea Co., Ltd. and others

- (b) Investment property pledged as collateral as of December 31, 2015 was as follows:

In millions of won

Asset	Carrying amount	Type	Received amount	Collateralized amount	Leaseholder
Investment property	₩ 70,769	Leasehold deposits received	₩ 8,975	9,225	Metlife Insurance Korea Co., Ltd. and others

17. Share Capital and Other Capital Surplus

- (a) Details of share capital as of September 30, 2016 and December 31, 2015 were as follows:

	September 30 2016	December 31 2015
Number of ordinary shares:		
Authorized	800,000,000	800,000,000
Issued	137,292,497	137,292,497
Outstanding	126,143,670	125,965,892
Par value in won	₩ 5,000	5,000

The Company has, thus far, reacquired and retired 53,699,400 shares of treasury share. Accordingly, as of September 30, 2016, the Company's ordinary share differs from the aggregate par value of issued shares by ₩268,497 million.

- (b) Changes in the number of shares for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

	2016			2015		
	Ordinary shares	Treasury shares	Total	Ordinary shares	Treasury shares	Total
Beginning balance	137,292,497	(11,326,605)	125,965,892	137,292,497	(11,393,697)	125,898,800
In-kind donation of treasury shares	-	177,778	177,778	-	67,092	67,092
Ending balance	137,292,497	(11,148,827)	126,143,670	137,292,497	(11,326,605)	125,965,892

- (c) There was no change in other capital surplus for the nine-month period ended September 30, 2016 and the year ended December 31, 2015.

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18. Treasury Shares and Gain on Reissuance of Treasury Shares

- (a) Changes in treasury shares for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won, except number of shares</i>	2016		2015	
	Number of shares	Carrying amount	Number of shares	Carrying amount
Beginning balance	11,326,605	₩ 337,062	11,393,697	₩ 339,059
In-kind donation of treasury shares	(177,778)	(5,290)	(67,092)	(1,997)
Ending balance	11,148,827	₩ 331,772	11,326,605	₩ 337,062

- (b) Changes in gain on reissuance of treasury shares for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won</i>	2016	2015
Beginning balance	₩ 494,648	492,032
In-kind donation of treasury shares, net of tax	10,544	2,616
Ending balance	₩ 505,192	494,648

19. Reserves

- (a) Details of reserves as of September 30, 2016 and December 31, 2015 were as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Available-for-sale financial assets - net change in fair value	₩ (42,828)	(45,128)
Legal reserve	602,937	602,937
Voluntary reserve	3,794,260	3,226,658
	₩ 4,354,369	3,784,467

- (b) Available-for-sale financial assets - net change in fair value as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Available-for-sale financial assets - net change in fair value before tax	₩ (56,501)	(59,536)
Tax effect	13,673	14,408
	₩ (42,828)	(45,128)

- (c) Legal Reserve

The Korean Commercial Act requires the Company to appropriate a legal reserve in 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 may be transferred to ordinary shares in connection with a free issue of shares.

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19. Reserves, Continued

(d) Details of voluntary reserve as of September 30, 2016 and December 31, 2015 were as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Reserve for business rationalization	₩ 12,851	12,851
Reserve for research and human resource development	20,000	30,000
Reserve for business expansion	698,881	698,881
Unconditional reserve	3,062,528	2,484,926
	₩ 3,794,260	3,226,658

Reserve for business rationalization

Until December 10, 2002 under *the Restriction of Special Taxation Act*, investment tax credits were allowed for certain investments. The Company was, however, required to appropriate from retained earnings, the amount of tax benefits received, and transfer such amount into a reserve for business rationalization.

Effective December 11, 2002, the Company was 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.

Reserve for research and human resource development

According to *the Restriction of Special Taxation Act*, certain taxable deductions are required to be transferred from retained earnings to reserve for research and human resource development. This reserve may be used for each purpose and their remaining amounts could be reclassified as a voluntary reserve.

Reserve for business expansion and other reserves

Reserves without specific purposes are restored to retained earnings by the Company. Those reserves can be used for other purposes afterwards upon a resolution at a general meeting of shareholders.

20. Retained Earnings

Changes in retained earnings for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won</i>	2016	2015
Beginning balance	₩ 995,886	736,460
Dividends	(428,284)	(428,056)
Transfer from reserve for research and human resource development	10,000	12,522
Transfer to unconditional reserve	(577,602)	(320,926)
Profit for the period	738,004	987,924
Remeasurements of net defined benefit liability, net of tax	(17)	7,962
Ending balance	₩ 737,987	995,886

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21. Trade and Other Payables

Trade and other payables as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>		September 30 2016		December 31 2015	
		Current	Non-current	Current	Non-current
Leasehold deposits received	₩	23,123	4,185	19,404	8,147
Trade payables		44,179	-	65,154	-
Withholdings		3,649	-	4,749	-
Withholdings value added tax		215,960	-	184,587	-
Accrued expenses		115,768	-	125,699	-
Other payables		32,071	-	34,231	-
	₩	434,750	4,185	433,824	8,147

22. Short-term Borrowings

Short-term borrowings as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	Annual interest rate		September 30 2016	December 31 2015
Customer credit contracts:				
Nonghyup Bank	6.09%	₩	3,598	4,099
KEB Hana Card Co., Ltd.	3M CD rate+2.5%		803	932
		₩	4,401	5,031

The Company has entered into a customer credit contract with the Nonghyup Bank and KEB Hana Card Co., Ltd. The financial institutions pay trade receivables for customers and the Company has provided guarantees to the financial institutions for customers.

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23. Retirement Benefits Plan

- (a) The components of retirement benefits for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016		2015	
	Three-month	Nine-month	Three-month	Nine-month
Defined benefit plans:				
Current service cost	₩ 6,225	18,674	7,096	21,287
Net interest cost	232	696	437	1,311
	6,457	19,370	7,533	22,598
Defined contribution plans:				
Contributions recognized as expense	1,647	4,236	990	3,031
	₩ 8,104	23,606	8,523	25,629

The Company recognized termination benefits amounting to ₩6,116 million as an expense for the nine-month period ended September 30, 2015.

- (b) Net defined benefit liability as of September 30, 2016 and December 31, 2015 is summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Present value of defined benefit obligations	₩ 251,286	247,774
Fair value of plan assets	(191,737)	(205,600)
Net defined benefit liability	₩ 59,549	42,174

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24. Revenue from Real Estate Sales

(a) Details of agreements for real estate sales under construction as of September 30, 2016 were as follows:

<i>In millions of won</i>	Construction period		Total revenue estimated	Total revenue contracted
Daegu Station Central-Xi	Dec. 2014 ~ Oct. 2017	₩	342,666	318,525

(b) Changes in the balance of contract amount for the nine-month period ended September 30, 2016 were as follows:

<i>In millions of won</i>	2016
Beginning balance	₩ 246,340
Revenue recognized	(71,517)
Ending balance	₩ 174,823

(c) Recognized profits and related balances for agreements under construction as of September 30, 2016 were as follows:

<i>In millions of won</i>	Stage of completion		Aggregate revenue recognized	Aggregate expenses recognized	Due from customers for contract work
Daegu Station Central-Xi	45.11%	₩	143,702	112,297	16,294

(d) There was no change in the estimates of total revenue and total costs during the nine-month period ended September 30, 2016. The total revenue and the total costs are estimated based on the information and circumstances available at the end of the reporting period and actual results may differ from these estimates.

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25. Result from Operating Activities

- (a) Details of expenses classified by nature for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Changes in inventories	₩	25,470	64,981	66,001	112,032
Raw materials and consumables purchased		158,987	517,425	115,081	428,828
Salaries		85,574	250,881	79,084	260,573
Retirement and termination benefits		8,104	23,606	8,523	31,745
Depreciation		26,600	78,644	26,361	78,899
Amortization		5	15	4	20
Employee welfare		12,189	34,298	14,024	48,930
Advertising		28,159	78,483	27,076	86,254
Commissions		26,954	80,171	25,970	74,245
Other expenses		32,501	72,675	24,306	60,312
	₩	404,543	1,201,179	386,430	1,181,838

- (b) Details of selling, general and administrative expenses for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Salaries	₩	57,480	169,231	53,510	175,949
Retirement and termination benefits		5,568	16,403	5,856	22,427
Employee welfare		8,965	25,000	9,896	34,396
Travel		1,822	4,464	1,357	3,463
Communications		812	2,520	825	2,558
Utilities		2,168	6,317	2,219	6,869
Taxes and dues		1,884	15,461	269	13,678
Supplies		302	1,097	339	1,378
Rent		3,520	9,848	3,144	10,053
Depreciation		7,941	23,958	8,214	24,495
Amortization		5	15	4	20
Repairs and maintenance		730	2,318	843	2,422
Vehicles		1,058	3,041	1,253	3,646
Insurance		58	235	73	244
Commissions		19,899	58,090	19,225	56,250
Freight and custody		5,584	17,596	8,090	21,911
Conferences		616	2,014	608	1,988
Advertising		28,129	78,373	27,053	86,150
Training		834	2,622	974	2,934
Prizes and rewards		301	904	372	1,323
Normal research and development		2,497	7,178	2,461	7,945
Impairment loss (reversal of impairment loss) on trade receivables		7	3	-	(279)
	₩	150,180	446,688	146,585	479,820

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26. Other Income and Expenses

- (a) Details of other income for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Foreign currency transaction gain	₩	1,766	12,841	12,747	18,952
Foreign currency translation gain		-	114	42,705	61,810
Reversal of impairment loss on other receivables		-	-	-	420
Gain on sale of property, plant and equipment		350	11,903	1,850	8,823
Gain on sale of intangible assets		-	-	-	723
Gain on sale of investments in associates		-	6,095	-	-
Others		4,842	13,430	4,339	18,192
	₩	6,958	44,383	61,641	108,920

- (b) Details of other expenses for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Foreign currency transaction loss	₩	11,701	21,656	1,488	6,647
Foreign currency translation loss		53,354	60,441	-	3,989
Impairment loss on other receivables		64	583	1,591	-
Donations		20,579	23,781	2,138	23,118
Loss on sale of property, plant and equipment		26	897	27	396
Loss on sale of intangible assets		3	8	-	-
Others		4,122	5,621	791	3,934
	₩	89,849	112,987	6,035	38,084

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27. Net Finance Income

- (a) Details of net finance income for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016		2015	
	Three-month	Nine-month	Three-month	Nine-month
Finance income:				
Interest income	₩ 8,514	26,948	8,751	24,285
Dividend income	1,895	13,322	909	11,865
Interest income on long-term deposits in MSA Escrow Fund	(535)	3,554	730	1,796
Gain on conversion of redeemable convertible preferred shares	-	311	-	-
Gain on valuation of derivative financial instruments	-	-	418	418
	9,874	44,135	10,808	38,364
Finance costs:				
Interest expense	(157)	(503)	(189)	(608)
Impairment loss on available-for-sale financial assets	-	-	(95)	(95)
	(157)	(503)	(284)	(703)
Net finance income	₩ 9,717	43,632	10,524	37,661

- (b) Details of interest expenses for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016		2015	
	Three-month	Nine-month	Three-month	Nine-month
Trade and other payables	₩ 157	503	189	608

- (c) Details of interest income for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016		2015	
	Three-month	Nine-month	Three-month	Nine-month
Deposits	₩ 6,533	20,629	6,937	18,545
Available-for-sale financial assets	8	22	7	32
Trade and other receivables	1,973	6,297	1,807	5,708
	₩ 8,514	26,948	8,751	24,285

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28. Income Tax

Income tax expense comprises as current tax expense adjusted for current adjustments for prior periods, deferred tax expense (income) by origination and reversal of deferred tax assets (liabilities), and income tax recognized in other comprehensive income. The average effective tax rate was 24.26% and 24.38% for the nine-month periods ended September 30, 2016 and 2015, respectively.

29. Earnings per Share

Basic and diluted earnings per share for the three- and nine-month periods ended September 30, 2016 and 2015 were as follows:

		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Profit for the period in millions of won	₩	207,988	738,004	288,881	813,265
Weighted-average number of ordinary shares outstanding		126,143,670	126,137,182	125,965,892	125,960,485
Basic and diluted earnings per share in won	₩	1,649	5,851	2,293	6,457

The weighted-average number of ordinary shares outstanding is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor.

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30. Transactions and Balances with Related Companies

(a) Details of parent and subsidiary relationships as of September 30, 2016 and December 31, 2015 were as follows:

Subsidiary	Location	Immediate parent company	Percentage of ownership					
			September 30 2016			December 31 2015		
			Parent	Sub-sidiary	Total	Parent	Sub-sidiary	Total
Korea Ginseng Corporation	Korea	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
Yungjin Pharm. Ind. Co., Ltd.	Korea	KT&G Corporation	53.00%	-	53.00%	53.00%	-	53.00%
Tae-a Industry Co., Ltd.	Korea	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	KT&G Corporation	99.99%	-	99.99%	99.99%	-	99.99%
Korea Tabacos do Brasil Ltda.	Brazil	KT&G Corporation	99.99%	-	99.99%	99.99%	-	99.99%
KT&G Pars	Iran	KT&G Corporation	99.99%	-	99.99%	99.99%	-	99.99%
KT&G Rus L.L.C.	Russia	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
KGC Life & Gin Co., Ltd.	Korea	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
Global Trading, Inc.	USA	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
Cosmococ Co., Ltd. ^{(*)1}	Korea	KT&G Corporation	98.49%	-	98.49%	97.73%	-	97.73%
Renzoluc Pte., Ltd. ^{(*)2}	Singapore	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Life Sciences Corporation ^{(*)3}	Korea	KT&G Corporation	31.19%	-	31.19%	73.94%	-	73.94%
KGC Yebon Corporation	Korea	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
K-Q HongKong I, Limited ^{(*)2}	HongKong	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
PT KT&G Indonesia	Indonesia	KT&G Corporation	99.99%	-	99.99%	99.99%	-	99.99%
K&I HK Co., Ltd.	HongKong	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
K&I China Co., Ltd.	China	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
SangSang Stay, Inc. ^{(*)4}	Korea	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Global Rus L.L.C. ^{(*)5}	Russia	KT&G Corporation	100.00%	-	100.00%	-	-	-
Jilin Hanzheng Ginseng Co., Ltd.	China	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Cheong Kwan Jang Taiwan Corporation	Taiwan	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korean Red Ginseng Corp., Inc.	USA	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng (China) Corp.	China	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng Corporation Japan	Japan	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
PT CKJ INDONESIA	Indonesia	Korea Ginseng Corporation	-	99.88%	99.88%	-	99.88%	99.88%
PT Trisakti Purwosari Makmur	Indonesia	Renzoluc Pte., Ltd.	-	60.17%	60.17%	-	60.17%	60.17%
PT Mandiri Maha Mulia	Indonesia	Renzoluc Pte., Ltd.	-	66.47%	66.47%	-	66.47%	66.47%
PT Sentosa Ababi Purwosari	Indonesia	PT Trisakti Purwosari Makmur	-	99.24%	99.24%	-	99.24%	99.24%
PT Purindo Ilufa	Indonesia	PT Trisakti Purwosari Makmur	-	100.00%	100.00%	-	100.00%	100.00%

(*)1 For the nine-month period ended September 30, 2016, the ownership interest in Cosmococ Co., Ltd. has increased to 98.49% from 97.73% as a result of the conversion of its redeemable convertible preferred shares.

(*)2 The percentage of ownership, shown above, excludes preferred shares. As of September 30, 2016, the Company's percentage of ownership would be 68.91% and 50.00%, respectively, if preferred shares are included.

(*)3 For the nine-month period ended September 30, 2016, the ownership interest in KT&G Life Sciences Corporation has decreased to 31.19% from 73.94% as a result of the conversion of its redeemable convertible preferred shares.

(*)4 The Company established SangSang Stay, Inc. in 2015.

(*)5 The Company established KT&G Global Rus L.L.C. in 2016.

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30. Transactions and Balances with Related Companies, Continued

(b) Significant transactions which occurred in the normal course of business with related companies for the three- and nine-month periods ended September 30, 2016 and 2015 are summarized as follows:

(i) Sales and other income

<i>In millions of won</i>		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Korea Ginseng Corporation	₩	1,944	5,808	2,125	6,458
Yungjin Pharm. Ind. Co., Ltd.		69	239	72	234
Tae-a Industry Co., Ltd.		3	10	3	14
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		375	1,086	2,291	6,329
KT&G Pars		-	323	-	941
KT&G Rus L.L.C.		3,189	18,541	8,151	20,007
KGC Life & Gin Co., Ltd.		90	297	100	335
Global Trading, Inc.		28,173	92,645	27,737	81,466
Cosmococ Co., Ltd.,		27	121	27	76
Renzoluc Pte., Ltd.		1,017	2,949	1,023	2,827
KT&G Life Sciences Corporation		4	15	4	26
KGC Yebon Corporation		-	96	121	472
PT KT&G Indonesia		374	1,207	385	1,164
K&I China Co., Ltd.		208	209	-	-
SangSang Stay, Inc.		1,443	2,201	-	-
PT Trisakti Purwosari Makmur		54	142	4	87
PT Mandiri Maha Mulia		1,719	3,648	976	2,580
	₩	38,689	129,537	43,019	123,016

In addition, the Company disposed of property, plant and equipment with a carrying amount of ₩4,920 million and ₩3,391 million to SangSang Stay, Inc. and PT Mandiri Maha Mulia, respectively, during the nine-month period ended September 30, 2016.

(ii) Purchase and other expenses

<i>In millions of won</i>		2016		2015	
		Three-month	Nine-month	Three-month	Nine-month
Korea Ginseng Corporation	₩	910	2,398	418	1,251
Yungjin Pharm. Ind. Co., Ltd.		3	11	2	14
Tae-a Industry Co., Ltd.		3,091	10,630	3,293	10,362
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		-	-	14	23
KGC Life & Gin Co., Ltd.		4	253	199	454
Cosmococ Co., Ltd.		10	417	26	93
KGC Yebon Corporation		-	260	30	102
K&I China Co., Ltd.		13	59	196	201
SangSang Stay, Inc.		-	33	-	-
	₩	4,031	14,061	4,178	12,500

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30. Transactions and Balances with Related Companies, Continued

(c) Account balances with related companies as of September 30, 2016 and December 31, 2015 were as follows:

<i>In millions of won</i>	September 30 2016		December 31 2015	
	Receivables	Payables	Receivables	Payables
Korea Ginseng Corporation	₩ 235	2,071	37	2,044
Yungjin Pharm. Ind. Co., Ltd.	-	30	11	413
Tae-a Industry Co., Ltd.	-	950	-	-
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	36,485	-	44,388	-
Korea Tabacos do Brasil Ltda.	100	-	99	-
KT&G Pars ^(*)	41,051	-	42,868	-
KT&G Rus L.L.C. ^(*)	50,811	-	38,425	-
KGC Life & Gin Co., Ltd.	-	165	-	245
Global Trading, Inc.	20,847	-	12,071	-
Cosmococ Co., Ltd.	7	27	28,144	28
Renzoluc Pte., Ltd.	48,764	-	47,884	-
KT&G Life Sciences Corporation	-	1	-	1
PT KT&G Indonesia	27,920	-	29,112	-
K&I China Co., Ltd.	209	-	-	-
PT Trisakti Purwosari Makmur	279	-	156	-
PT Mandiri Maha Mulia	7,291	-	3,698	-
	₩ 233,999	3,244	246,893	2,731

^(*) Above receivables are the gross amounts before ₩20,781 million and ₩20,198 million of allowance for doubtful accounts as of September 30, 2016 and December 31, 2015, respectively.

(d) During the nine-month period ended September 30, 2016, the Company acquired ₩27,418 million of additional shares of Cosmococ Co., Ltd. as a result of the conversion of its redeemable convertible preferred shares.

(e) Details of key management personnel compensation for the three- and nine-month periods ended September 30, 2016 and 2015 are summarized as follows:

<i>In millions of won</i>	2016		2015	
	Three-month	Nine-month	Three-month	Nine-month
Short-term employee benefits	₩ 3,762	11,317	2,102	11,193
Retirement benefits	455	1,263	240	1,144
	₩ 4,217	12,580	2,342	12,337

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31. Risk Management and Fair Value of Financial Instruments

(a) Overview

The Company has exposure to the following risks from its use of financial instruments:

- Market risk
- Credit risk
- Liquidity risk

This note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk including quantitative disclosures.

(b) Risk Management Framework

The purpose of managing financial risks is to identify the potential risk factors that may affect the Company's financial performance, and minimize, eliminate and avoid it to the extent that is acceptable. One of the principal responsibilities of the treasury department is to manage the financial risks arising from the Company's underlying operations. The treasury department monitors and manages the financial risk arising from the Company's underlying operations in accordance with the risk management policies and procedures authorized by the board of directors. Also, the treasury department provides an internal report analyzing the nature and exposure level of financial risks to Risk Management Committee of the Company. The Risk Management Committee prepares the overall strategy for financial risk management, and evaluates the effectiveness of the financial risk management strategy. In addition, the Company's audit committee consistently observes the compliance of the risk management policy and procedure, and reviews the risk exposure limit of the Company. The Company applied the same financial risk management strategy that was applied in the previous period.

(c) Management of Financial Risks

(i) Market risk

Market risk is the risk that changes in market prices – such as foreign exchange rates, interest rates and equity prices – will affect the Company's income or the value of its financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimizing the return.

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31. Risk Management and Fair Value of Financial Instruments, Continued

(c) Management of Financial Risks, Continued

Currency risk

The Company has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates arising from the export and import of tobacco. The Company's management has measured the currency risk internally and regularly, and has entered into foreign currency forward contracts to hedge foreign currency risk, if necessary.

The carrying amounts of monetary assets and liabilities denominated in a currency other than the functional currency as of September 30, 2016 and December 31, 2015 were as follows:

<i>In millions of won</i>		September 30 2016		December 31 2015	
		Assets	Liabilities	Assets	Liabilities
USD	₩	974,940	3,305	918,070	44,431
IDR		48,764	-	48,190	-
EUR		28,061	2,186	30,375	1,504
Others		6,561	-	2,177	-
	₩	1,058,326	5,491	998,812	45,935

As of September 30, 2016 and December 31, 2015, the effects of a 10% weakening or strengthening of functional currency against foreign currencies on profit before tax were as follows:

<i>In millions of won</i>		September 30 2016		December 31 2015	
		10% weakening	10% strengthening	10% weakening	10% strengthening
Increase (decrease) in profit before tax	₩	105,284	(105,284)	95,288	(95,288)

Equity price risk

The Company has exposure to equity price risk, which arises from listed available-for-sale equity instruments. The Company's management has monitored the proportion of equity instruments in its investment portfolio based on market indices. Material investments within the portfolio are managed on an individual basis, and all buy and sell decisions are approved by the Company's management.

As of September 30, 2016 and December 31, 2015, the effects of a 5% fluctuation in the price index of stocks on comprehensive income before tax were as follows:

<i>In millions of won</i>		September 30 2016		December 31 2015	
		5% increase	5% decrease	5% increase	5% decrease
Comprehensive income before tax	₩	4,831	(4,831)	1,627	(1,627)

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31. Risk Management and Fair Value of Financial Instruments, Continued

(c) Management of Financial Risks, Continued

Interest rate risk

The Company has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company's management has monitored the level of interest rates regularly and has maintained the balance of borrowings at variable rates and fixed rates. As of September 30, 2016, there is no significant effect on cash flows or the fair value of financial liabilities from the interest rate fluctuation, considering the amounts of interest bearing liabilities.

(ii) Credit risk

The Company has exposure to the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. The Company has transacted with customers with high credit ratings to manage credit risk, and has implemented and operated policies and procedures for credit enhancements of the financial assets. Counterparty credit risk is managed by evaluating its credit rating and limiting the aggregate amount and duration of exposure before sales commence, and the Company has been provided collateral and guarantees. The credit ratings of all counterparties and the level of collateral and guarantees are reviewed regularly. Analysis of financial assets past due has been reported quarterly and appropriate measures have been taken to secure the Company's assets.

The carrying amount of financial assets is maximum exposure to credit risk. The maximum exposure to credit risk as of September 30, 2016 and December 31, 2015 is as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Available-for-sale debt instruments	₩ 1,500	1,500
Long-term deposits in MSA Escrow Fund	444,696	403,966
Trade and other receivables	1,242,613	1,153,462
Other financial assets (excluding derivatives)	1,070,000	1,080,000
Cash and cash equivalents (excluding cash on hand)	465,498	441,753
Financial guarantee contracts	114,855	76,566
	₩ 3,339,162	3,157,247

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31. Risk Management and Fair Value of Financial Instruments, Continued

(c) Management of Financial Risks, Continued

(iii) Liquidity risk

The Company has exposure to the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. The Company's management has established short-term and long-term financial management plans to manage the liquidity risk, and analyzed cash outflows occurred and cash outflows budgeted, so as to match the maturity structure of financial assets and financial liabilities. The Company's management determines whether or not the financial liabilities are repayable with the operating cash flows and cash inflows from financial assets.

The maturity analysis with a residual contractual maturity of financial liabilities as of September 30, 2016 and December 31, 2015 is as follows:

<i>In millions of won</i>	Carrying amount	Contractual cash flow	Residual contractual maturity			
			Within 3 months	Between 3 months and 1 year	Between 1 and 5 years	
As of September 30, 2016:						
Trade and other payables	₩ 219,326	219,767	192,018	23,337	4,412	
Short-term borrowings	4,401	4,401	4,401	-	-	
Financial guarantee contracts	-	114,855	-	-	114,855	
	₩ 223,727	339,023	196,419	23,337	119,267	
As of December 31, 2015:						
Trade and other payables	₩ 252,635	253,343	225,084	19,583	8,676	
Short-term borrowings	5,031	5,031	5,031	-	-	
Financial guarantee contracts	-	76,566	-	-	76,566	
	₩ 257,666	334,940	230,115	19,583	85,242	

The above financial liabilities are presented at the nominal value of undiscounted future cash flows as of the earliest period at which the Company can be required to pay.

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31. Risk Management and Fair Value of Financial Instruments, Continued

(d) Fair Value of Financial Instruments

The carrying amounts of each category of financial assets and liabilities as of September 30, 2016 and December 31, 2015 are summarized as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Financial assets:		
Financial assets at fair value through profit or loss (derivative financial instruments)	₩ -	11,976
Available-for-sale financial assets	358,184	340,149
Loans and receivables		
–Trade and other receivables	1,242,613	1,153,462
–Long-term deposits in MSA Escrow Fund	444,696	403,966
–Other financial assets (excluding derivatives)	1,070,000	1,080,000
–Cash and cash equivalents	467,290	444,376
	3,224,599	3,081,804
	₩ 3,582,783	3,433,929
Financial liabilities:		
Financial liabilities measured at amortized cost		
–Trade and other payables	₩ 219,326	252,635
–Short-term borrowings	4,401	5,031
	₩ 223,727	257,666

The fair value measurements classified by fair value hierarchy as of September 30, 2016 and December 31, 2015 were as follows:

<i>In millions of won</i>	Carrying amount	Level I	Level II	Fair value Level III
As of September 30, 2016:				
Available-for-sale financial assets	₩ 305,629	189,540	-	116,089
As of December 31, 2015:				
Available-for-sale financial assets	₩ 302,594	187,486	-	115,108
Other financial assets (derivative financial instruments)	11,976	-	-	11,976
	₩ 314,570	187,486	-	127,084

There is no transfer between fair value hierarchy levels of recurring fair value measurements for the nine-month period ended September 30, 2016 and the year ended December 31, 2015.

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31. Risk Management and Fair Value of Financial Instruments, Continued

(d) Fair Value of Financial Instruments, Continued

The fair value measurements for available-for-sale equity instruments in real estate trust fund and derivative financial instruments have been measured using the adjusted net asset method, DCF and option pricing model and categorized as a level 3 fair value based on the inputs to the valuation techniques used. Changes in fair value classified as level 3 for the nine-month period ended September 30, 2016 and the year ended December 31, 2015 were as follows:

<i>In millions of won</i>		2016	2015
Beginning balance	₩	127,084	90,726
Acquisition		-	33,073
Exercise of conversion options		(11,976)	-
Changes in fair value		981	3,285
Ending balance	₩	116,089	127,084

(e) Finance Income (Costs)

(i) Details of finance income (costs) by categories for the nine-month period ended September 30, 2016 were as follows:

<i>In millions of won</i>		Available -for-sale Financial assets	Loans and receivables	Financial liabilities measured at amortized cost	Total
Profit or loss:					
Interest income	₩	22	26,926	-	26,948
Dividend income		11,446	-	-	11,446
Interest income on long-term deposits in MSA Escrow Fund		-	3,554	-	3,554
Gain on conversion of redeemable convertible preferred shares		-	311	-	311
Interest expense		-	-	(503)	(503)
	₩	11,468	30,791	(503)	41,756
Other comprehensive income before tax					
Net change in fair value	₩	3,035	-	-	3,035

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31. Risk Management and Fair Value of Financial Instruments, Continued

(e) Finance Income (Costs), Continued

(ii) Details of finance income (costs) by categories for the nine-month period ended September 30, 2015 were as follows:

<i>In millions of won</i>	Financial assets at fair value through profit or loss	Available-for-sale financial assets	Loans and receivables	Financial liabilities measured at amortized cost	Total
Profit or loss:					
Interest income	₩ -	32	24,253	-	24,285
Dividend income	-	8,303	-	-	8,303
Investment income on long-term deposits in MSA Escrow Fund	-	-	1,796	-	1,796
Gain on valuation of derivative financial instruments	418	-	-	-	418
Impairment loss on available-for-sale financial assets	-	(95)	-	-	(95)
Interest expense	-	-	-	(608)	(608)
	₩ 418	8,240	26,049	(608)	34,099
Other comprehensive loss before tax					
Net change in fair value	₩ -	(10,080)	-	-	(10,080)
Reclassification adjustments upon impairment	-	95	-	-	95
	₩ -	(9,985)	-	-	(9,985)

32. Capital Management

The Company's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The board of directors seeks to maintain a balance between the higher returns that might be possible with higher levels of borrowings and the advantages and security afforded by a sound capital position.

The Company monitors capital using equity and net debt deducting cash and cash equivalents and current financial instruments from borrowings. The Company applied the same capital management strategy that was applied in the previous year.

As of September 30, 2016 and December 31, 2015, the Company's capital structure was as follows:

<i>In millions of won</i>	September 30 2016	December 31 2015
Debt (borrowings)	₩ 4,401	5,031
Less:		
Cash and cash equivalents	(467,290)	(444,376)
Current other financial assets	(1,070,000)	(1,091,976)
Net debt (asset)	(1,532,889)	(1,531,321)
Equity	₩ 6,224,317	5,896,480

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33. Contingent Liabilities and Commitments

- (a) Each year the Company deposits a proportion of sales of tobacco products in the United States in accordance with the Tobacco Master Settlement Agreement (“MSA”) under the Escrow Statute of the United States government. The MSA Escrow Funds are maintained to pay the medical expenses of tobacco purchasers who have suffered health effects as a result of smoking. The unused portion of this fund will be refunded to the Company 25 years from the date of each annual funding. The Company recorded as long-term deposits the amounts paid into the MSA Escrow Funds of State governments in the United States against potential litigation and damages related to the export of tobacco into the United States.
- (b) As of September 30, 2016, a lawsuit by National Health Insurance Service claiming damages of ₩53,742 million is filed against the Company. Additionally, as of September 30, 2016, the Company is involved in six lawsuits as a plaintiff for alleged damages totalling ₩15,158 million and four lawsuits as a defendant for alleged damages totalling ₩1,688 million. The amount of the liability the Company may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of September 30, 2016.
- (c) As of September 30, 2016, the Company has entered into letter of credit agreements with KEB Hana Bank and other banks with limits in the aggregate of USD 59,000 thousand.
- (d) As of September 30, 2016, the Company’s trade receivables from the export of cigarettes are insured against non-payment up to USD 20,627 thousand by short-term export insurances with the Korea Trade Insurance Corporation.
- (e) The Company has been provided with a foreign currency payment guarantee by KEB Hana Bank up to USD 40,000 thousand for L/C or guarantees related with its foreign exports. Details of guarantees exercised as of September 30, 2016, are summarized as follows:

<i>In thousands of USD, THB and millions of IDR</i>		<i>Exercised amount</i>
Customs bond and L/C opening of Global Trading, Inc.	USD	14,222
Bidding guarantee for export of tobacco sheet to Taiwan Tobacco and Liquor Corporation	USD	85
Performance guarantee for export of tobacco sheet to Thailand Tobacco Monopoly	THB	11,980
Payment guarantee for purchase of certificate stamp of PT Mandiri Maha Mulia	IDR	175,166

- (f) On March 17, 2011, the Company signed the memorandum of understanding (“MOU”) on global investment partnership with National Pension Service to jointly invest in foreign assets with a limit of ₩800,000 million.

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33. Contingent Liabilities and Commitments, Continued

- (g) With relation to the acquisition of KT&G Life Sciences Corporation, the Company entered into a contract with a former owner of the acquiree, Gwak, Tae-Hwan (“Individual Shareholder”). Details of the contract are as follows:

Description	Details
Restriction of disposal	Individual Shareholder shall not be permitted to dispose of its shares, in whole or in part, within one year after KT&G Life Sciences Corporation is listed.
Right of first refusal held by the Company	Individual Shareholder shall not be permitted to make any transfer of its shares, in whole or in part, unless Individual Shareholder has offered them first to the Company.
Tag-along right held by Individual Shareholder	In the event that the Company proposes to enter into a transaction or a series of related transactions with a third party purchaser to dispose of its shares, then Individual Shareholder shall elect to participate in such disposition upon the terms and conditions no less favorable than those applicable to the Company.

- (h) As of September 30, 2016, the Company has provided guarantees up to ~~₩~~225,600 million with an exercised amount of ~~₩~~114,855 million for the buyers of apartments in respect of their borrowings from Shinhan Bank.
- (i) As of September 30, 2016, the Company is insured by performance bond insurance up to ~~₩~~1,346 million with the Seoul Guarantee Insurance.

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34. Cash Flows

- (a) Details of cash generated from operations for the nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016	2015
Profit for the period	₩ 738,004	813,265
Adjustments for:		
Income tax expense	236,405	262,257
Finance costs	503	703
Finance income	(44,135)	(38,364)
Depreciation	78,644	78,899
Amortization	15	20
Retirement and termination benefits	23,606	31,745
Foreign currency translations loss	60,441	3,989
Impairment loss on trade and other receivables	586	-
Write-down (reversal of write-down) of inventories	178	(165)
Loss on sale of property, plant and equipment	897	396
Loss on sale of intangible assets	8	-
Other expense, etc.	2,087	6,442
Foreign currency translations gain	(114)	(61,810)
Reversal of impairment loss on trade and other receivables	-	(699)
Gain on sale of property, plant and equipment	(11,903)	(8,823)
Gain on sale of intangible assets	-	(723)
Gain on sale of investment in associates	(6,095)	-
	1,079,127	1,087,132
Changes in working capital:		
Trade and other receivables	(135,508)	(170,029)
Advance payments	(16,756)	(26,325)
Prepaid expenses	2,136	170
Prepaid tobacco excise and other taxes	8,278	(145,318)
Inventories	62,716	111,203
Trade and other payables	17,035	72,606
Advance receipts	(23,784)	2,942
Tobacco excise and other taxes payable	(92,793)	396,777
Payment of retirement and termination benefits	(7,706)	(11,005)
Cash generated from operations	₩ 892,745	1,318,153

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34. Cash Flows, Continued

- (b) Details of material transactions without cash inflow and outflow for the nine-month periods ended September 30, 2016 and 2015 were as follows:

<i>In millions of won</i>	2016	2015
In-kind donation of treasury shares	₩ 19,200	5,448
Acquisition of investment in subsidiaries resulting from the conversion of redeemable convertible preferred shares	27,415	-
Increase (decrease) in accrued expenses related to payment of retirement and termination benefits	(1,452)	22
Increase in other payables related to acquisition of property, plant and equipment	896	3,360
Increase (decrease) in advance receipts related to disposal of property, plant and equipment and non-current assets held for sale	(422)	758
Increase in other receivables related with disposal of property, plant and equipment and non-current assets held for sale	3,129	-

- (c) The Company presented cash flows arising from short-term financial instruments on a net basis.