

2011 Annual Report

# Seeds of Imagination Turn into **KT&G**



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KT&G pursues righteousness based on transparency, enlightenment through constant innovation, and companionship by fulfilling social responsibilities. We become an excellent world company by maximizing efforts and values for all customers, shareholders and employees.

### Righteousness

KT&G pursues a company of social norms and rationality. It places priority on the interests of all shareholders and sound corporate governance to enhance shareholder value. With our commitment to corporate ethics and advanced governance structure, we have gained the trust of shareholders, investors and other stakeholders. KT&G, emphasizing the need to be discretionary and creative among staffs and employees, pursues always future-oriented management and maintain integrity as a 'righteous company' based on their responsibilities.

### Enlightenment

As KT&G enlightened, we embrace 'change and innovation' as a goal in its own right rather than a means to an end. Amidst a more competitive global market where the business environment is changing rapidly, we are strengthening our competitiveness through innovation in our business activities. Our investments in the areas of new drugs, cosmetics, and health care will lay the basis for the company's globalization. With a balanced business portfolio, KT&G will work to help the society grow sustainably with us.

### Companionship

As a 'company pursuing companionship', KT&G creates the utmost value and rewards for our customers, shareholders, and all other constituents. We actively accommodate social norms to serve the public good and fulfill our corporate social responsibility.

Under the slogan of 'Imagining a better tomorrow,' KT&G is engaged in creating basic social values that the era requires in various ways through the Welfare Foundation, the Scholarship Foundation, CSR initiatives, volunteer activities by our employees. We will strive to create more value to our customers by interacting with and supporting the socially disadvantaged groups, cultural and scholarship programs.

# Financial Highlight

## Key Financials

[in billions of KRW]

	2007	2008	2009	2010	2011
Net Sales	2,413	2,573	2,776	2,500	2,491
Operating Profit	814	1,046	947	925	933
Net Profit	661	850	745	931	776
Total Assets	3,978	4,614	4,788	5,254	5,418
Total Liabilities	836	1,159	935	916	874
Total Shareholders' Equity	3,142	3,454	3,853	4,338	4,544

## Index

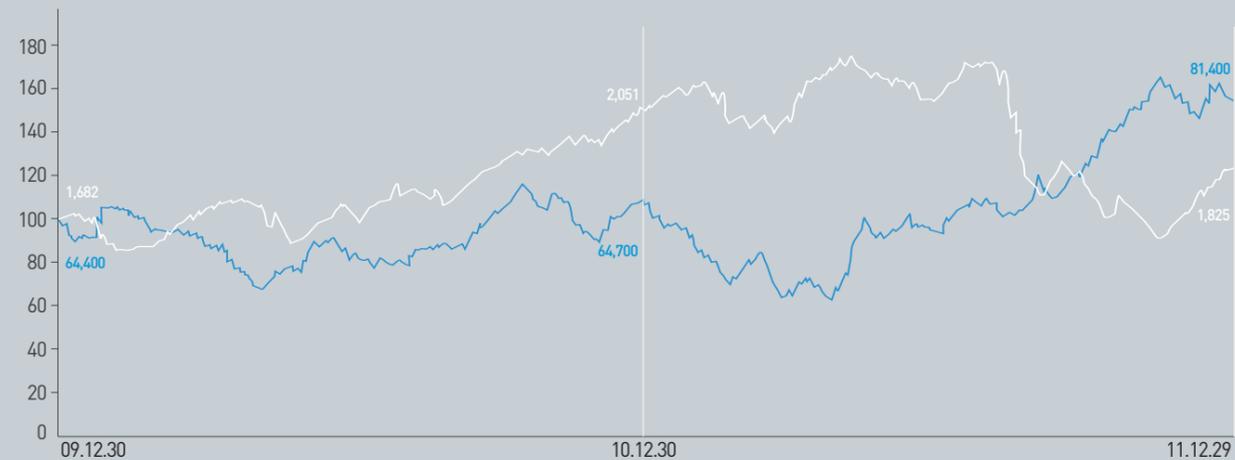
[%, KRW]

	2007	2008	2009	2010	2011
ROA	17.3	19.8	15.8	18.5	14.5
ROE	21.4	25.8	20.4	22.7	17.5
Operating Profit Margin	33.8	40.7	34.1	37.0	37.5
Net Profit Margin	27.4	33.0	26.8	37.2	31.2
EPS(KRW)	4,992	6,527	5,803	7,317	6,134
Payout Ratio	51.5	40.3	47.8	41.0	51.9
DPS	2,600	2,800	2,800	3,000	3,200
Liabilities-to-equity Ratio	26.6	33.6	24.3	21.1	19.2
Net debt-to-equity Ratio	-	-	-	-	-

※ Figures for 2008-2011 are based on the Korean International Financial Reporting Standards(K-IFRS).

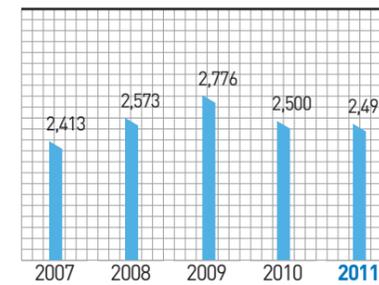
## KT&G Stock Price

(2009.12=100) — KOSPI — KT&G



## Net Sales

[in billions of KRW]



## Operating Profit & Margin

[in billions of KRW, %]



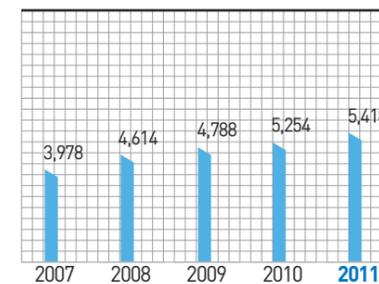
## Net Profit & Margin

[in billions of KRW, %]



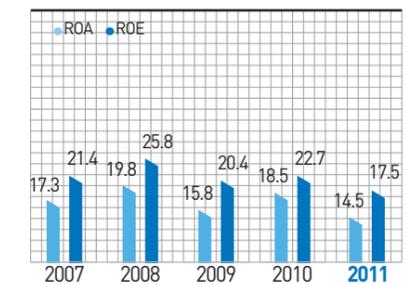
## Total Assets

[in billions of KRW]



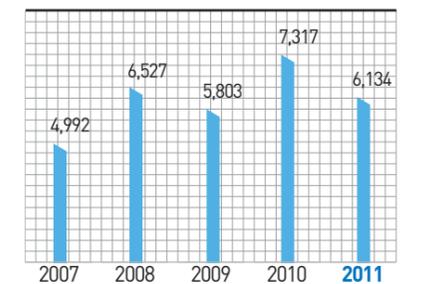
## ROA & ROE

[%]



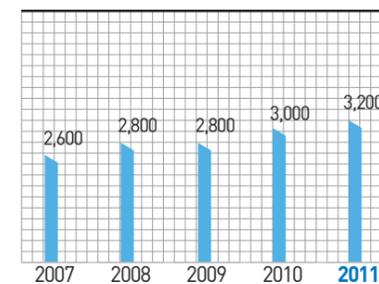
## EPS

[KRW]



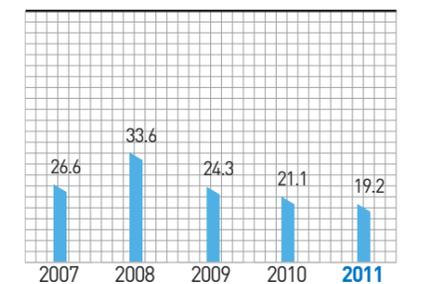
## DPS

[KRW]



## Liabilities-to-Equity Ratio

[%]



## CEO's Message



### Dear Fellow Shareholders,

On behalf of KT&G, I would like to begin by extending my gratitude all our shareholders for the support you showed us over the past year. Amid increased economic uncertainty of world economy in 2011, KT&G strived to jump up to be 'a leading global company'. Upholding our principle of "looking far and ahead", we revamped our organization and human resource structure, promoted performance-based evaluation, and innovated the way we carry out our business activities in an effort to strengthen our fundamentals for better performance.

We could succeed in the turnaround of M/S through launching new products like Bohem Mojito and efficiently responding to the market and gaining the upper hand in the fiercely competitive domestic tobacco market.

In the overseas tobacco business, we reinforced our organization by exploring new markets and raising profitability. As a results, the sales of our products increased by 12 percent compared to the previous year.

By reinforcing the premium brand image of 'Cheong Kwan Jang', red ginseng business is preparing to more proactively penetrate the international premium ginseng market by establishing direct overseas management system and extending domestic sales structure.

We also focused on developing new growth engines in an effort to remove the concerns of the shareholders over the current market situation; KT&G has recently acquired Trisakti, an Indonesian tobacco company and, started to build a local manufacturing plant in Jilin Province of China as a strategy to directly make inroads into the world's largest market for ginseng and ginseng products.

KT&G extended its best efforts to build a more balanced business portfolio incorporating tobacco business, health functional food and cosmetics areas. By taking over Somang Cosmetics and KT&G Life Sciences Corporation, a biotech venture, KT&G is trying to become a global company equipped with both growth potential and profitability.

Global economic slowdown, greater currency fluctuation and inflation are expected to create a tough business environment in 2012. Regardless of the difficulties surrounding us, KT&G will make further strides to increase corporate value and grow into a global blue-chip company.

In the tobacco business, we will pursue a differentiated marketing, strengthen sales capabilities and nurture core brands to continue to reclaim M/S. Moreover, KT&G will bolster sales in the overseas market by exploring new markets.

KGC will upgrade its technology and brand image by creating new ideas for differentiation and solidify our first position in domestic market. Efforts will also be made to expand overseas sales.

The health business, will be cultivated to bring fruitful results by maximizing synergy with our core businesses.

Additionally, KT&G will pursue long-term investments opportunities aimed at sustaining growth for stable generation of profits for shareholders. With a positive attitude, ongoing innovation and creative ideas, KT&G promise to do our best to maximize shareholders' value. We will make every effort to create and deliver satisfaction for all of our shareholders.

Thank you.

Min, Young-Jin  
President & CEO

## Diversification of Business, Globalization of KT&G

### 1. Acquisition of Somang Cosmetics



KT&G is entering into the cosmetics market by acquisition of Somang Cosmetics on 24th of June, 2011. Somang Cosmetics has brand names such as "Man with Flower" and oriental hub cosmetics "Danahan". High value and sustainable demand based, oriental cosmetic market especially records nearly 11% of annual growth. KT&G is planning to expand its business lines with this new business of Somang Cosmetics. Consumer confidence in R&D, production know-how and distribution channels are expected to produce synergy effects.

### 2. Groundbreaking Ceremony of Jilin Hanzheng Ginseng Co., Ltd.



As C1 step toward the localization effort, KT&G builds a manufacturing plant, Jilin Hanzheng Ginseng Co., Ltd. in the City of Yanji located in the Yanbian Prefecture of China. The Yanji ginseng warehouse groundbreaking ceremony took place on June 27. Utilizing the technology and knowhow of KT&G, the company will be able to provide and develop ginseng products of custom-tailored to local taste. By establishing a overseas operation, KT&G is finally moving into the world's biggest ginseng market and will eventually become the world's leading health food company.

### 3. Takeover of Indonesian Tobacco Co. 'Trisakti'



KT&G bought an Indonesian tobacco company 'Trisakti' by the final sign on October 7 in Singapore. It is expected to be a driving force behind our expansion of Indonesian tobacco market, the market of great growth potential. In 2010, Trisakti ranked 6th in kretek sales in Indonesia. By utilizing KT&G's white tobacco producing technology and Trisakti's kretek technology, it is expected to serve as a bridge-head for the expansion of local market as well as the exploration of the new markets.

### 4. Market Share Bounced & Mojito Waved



The One etipac, the one and only side-stream smoke in Korea, and Bohem cigar Mojito were launched in 8 June. The two products, each with their distinct features, have been well received in the marketplace as soon as they were released. Especially, with the fresh and exotic fragrance of Cuban rum's cocktail, Bohem cigar Mojito has brought a breath of fresh air into regular high tar content menthol market.

### 5. 2011 Award of Excellence in Corporate Governance



Korea Corporate Governance Service (KCGS) presented KT&G with the award of excellence in corporate governance in the KOSPI category at its 2011 awards ceremony. KT&G was recognized for

practicing shareholder-oriented management through efforts to improve corporate governance and highly rated(1st) for its performance in 'Effect on the Environment and Society' which the report has newly assessed in 2011. KT&G has received the award of distinction for corporate governance since 2003 and has been inducted into the hall of fame for 3 consecutive years since 2007.

### 6. KT&G, Added Twice to the DJSI World



KT&G was added to the Dow Jones Sustainability World Index (DJSI World) in 2011 for its industry-leading sustainability initiatives. Announced and included in the DJSI 2010 additions, KT&G once more showed our world-class competence in sustainable management. The DJSI World Index is a highly recognized sustainability index comprised of leading sustainable companies around the world. Inclusion on this list means that the company ranks in the top 10 percent of the biggest 2,500 companies worldwide based on long-term economic, environmental and social criteria.

### 7. Introduction Product Real-name System



As a leader of eco-friendly management, KT&G introduced a product real-name system firstly in Korean tobacco market. Since August 2011, this system has been applied to all of the products, in an effort to bolster public confidence and trust. The packed date and producer's name are indicated on the base side of cigarette pack. Besides, the plant and machine number, subtitle and date of production are indicated on the top and the production time and name of the chief of production line team on the bottom. KT&G will be able to spur production and distribution by reinforcing standardization, improvement of quality and guarantee of taste.

### 8. Creation of Sangsang Fund, KT&G's Donation Culture



KT&G created "Sangsang Fund" to promote a donating culture that individual executives and employees can freely participate, breaking the conventional bound of company-centric donation. On a request basis, the Sangsang Fund is generated by donations adding fixed funds and fractions of monthly wages under 10,000 won. The company would offer a matching grant by turning an hour of voluntary work into 10,000 won, adding the amount to donation fund.

Seeds of Imagination  
Turn into **KT&G**



**Creativity and Innovation lead**

**Sustainable Growth**

**Vision & Strategy**

- Corporate Vision
- Vision & Strategy for Sustainability
- Application of Sustainable Management Elements and Feedback Process
- KT&G Philosophy
- KT&G Core Values
- KT&G Vision
- KT&G Value System
- Staffs & Employees Value-I'm C.E.O.
- 'EVER-KT&G 2015', its Strategical Tasks and Expected Effectiveness

**KT&G Medium and Long Term Business Strategy**

**Business Review & Global Business - Tobacco**

- Greater Corporate Competitiveness
- Tobacco Brand Strategy for Differentiation

**Mutual Growth with the Affiliated Companies**

- Sales Presentation

**Product Liability and Competitiveness in Quality**

- Production Research & Development

**Tobacco in Turning-up**

- Product Line-up
- Commitment to Quality & Eco Friendly Management
- Our R&D Direction
- Products line-up

**Operation Review**

**Financial Review (Management Discussion & Analysis)**

- Executive Summary
- Operating Result Analysis
- Operating Revenues
- Operating Profitability
- Earnings and Dividends
- Financial Condition Analysis
- Cash Flow Analysis

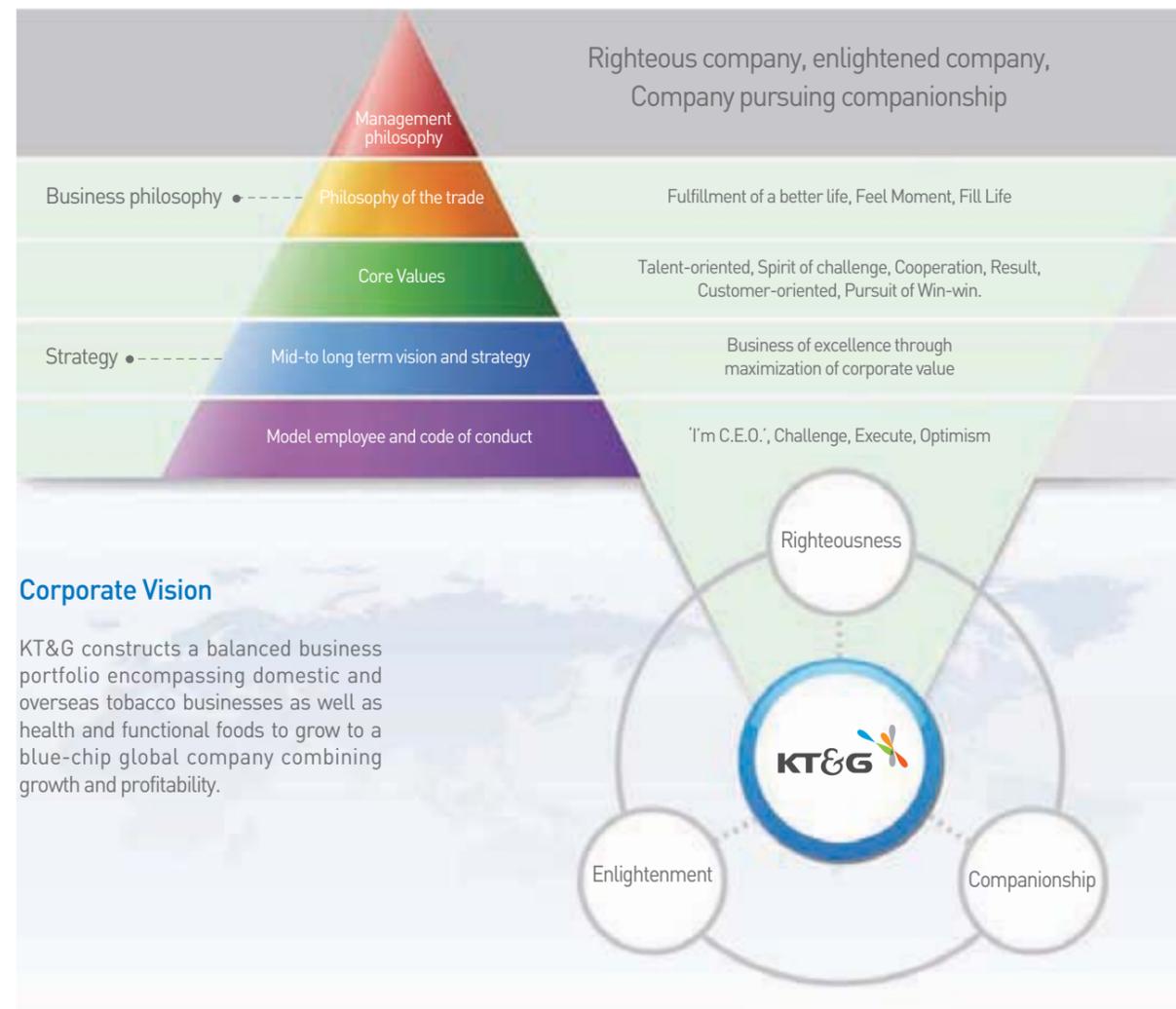
**2012 Business Plan & Outlook**

# Vision & Strategy

## KT&G, Creator of New Values

KT&G constructs a balanced business portfolio encompassing domestic and overseas tobacco businesses as well as health and functional foods to grow into a global blue-chip company combining growth and profitability.

KT&G's ultimate goal is to maximize value for customers, shareholders and all members of society. We have aligned our management philosophy, principles and vision accordingly and continued to make our best effort to realize our goal. In line with our three core beliefs of "righteousness," "enlightenment" and "companionship", we strive to deliver products and services that are based on trust and complete our "Feel Moment, Fill Life" vision by fulfilling the values of taste, vitality, well-being and health. Through this process, we are making strides toward becoming a global tobacco company, global health company and leading domestic pharmaceutical company while pursuing stable and continued creation of corporate value and growth into a global corporation.



## Sustainable Management Goal for Blue-Chip Company, "EVER-KT&G 2015"

## Vision & Strategy for Sustainability

Our sustainable business management goal is "EVER-KT&G 2015." E in Ever stands for "Excellent" economic performance; V for economic, environmental and social "Value creating"; E for "Eco-friendly" company; and R for "Responsible" business that fulfills its social responsibility. This is a reflection of KT&G's commitment to sustainable business management for the economy, society, and environment. The KT&G Post 2015, a vision and strategy for sustainable business management after 2015, will be drawn up in the future.

## Application of Sustainable Management Elements and Feedback Process

KT&G has established a sustainable business management strategy in economic, social, and environmental areas and established company-wide and department-specific action plans. For practical results, sustainable business management will become part of our corporate culture. To this end, we will encourage discussions among relevant departments, while carrying out performance management and evaluation.



## KT&G Philosophy

Righteousness,  
Enlightenment,  
Companionship

## KT&G Core Values

Talent-oriented, Spirit of challenge,  
Cooperation, Result, Customer-oriented,  
Pursuit of Win-win.

## KT&G Vision

KT&G aims to be a global blue-chip  
company by maximizing corporate and  
human values.

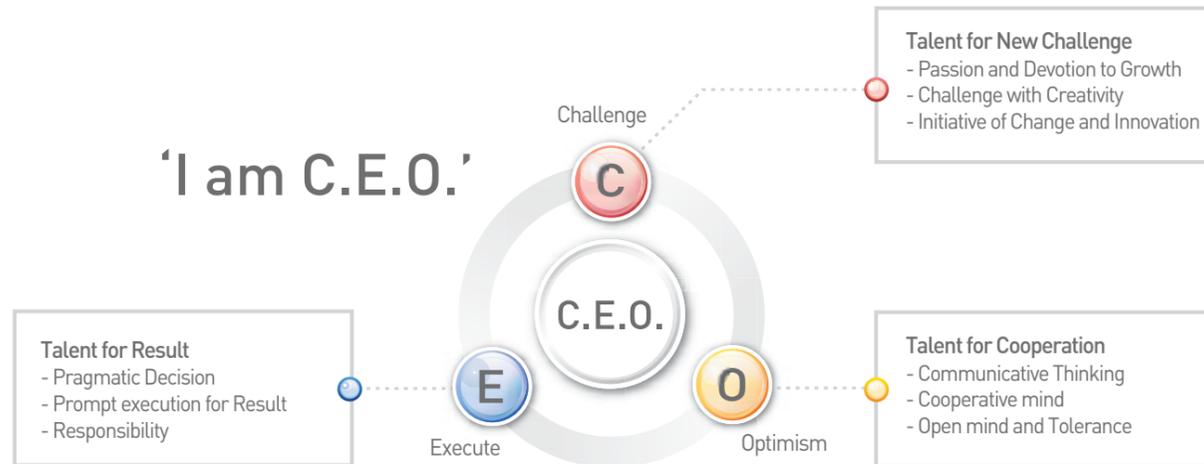
## KT&G Value System

Because our products and services based  
on customers' trust are of the highest  
priority, KT&G introduced a new  
management system for reinforcing  
responsibility and ethical management.  
We want to be a leading company for  
others to continue to innovate with our  
three core beliefs: "righteousness",  
"enlightenment" and "companionship"



## Staffs & Employees Value-I'm C.E.O.

A change is needed in management system and all the employees need to discover their talents each other. KT&G will respond to this human changing economic environment and enhance its value. KT&G aims to be a up-to-date-oriented company by maximizing human creativity corporate value based on responsibility management system. To this end, KT&G formulated a new vision-growth, profitability, trust, sustainability of becoming a global blue-chip company by rebuilding the business portfolio: tobacco, health functional foods, pharmaceuticals and cosmetics.

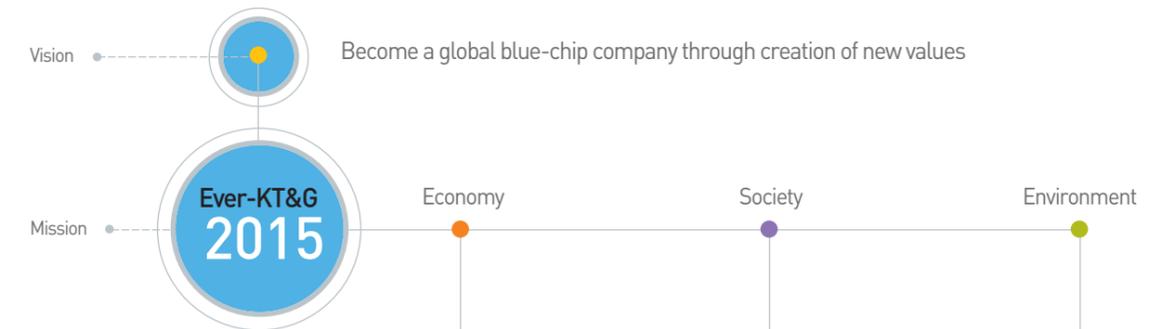


KT&G is a global blue-chip company with a permanent policy to maximize value for progressive and creative corporate culture. We have established our business goals and principle strategies associated each other and continue to make our best effort to realize corporate growth and social progress. In line with our beliefs, we strive to deliver reliable products and services and our core values of talent, challenge, cooperation, result, customer-oriented, win-win. Through this process for 'maximization of corporate value' on which our "EVER-KT&G 2015" management goal is based, we are making strides toward becoming a global blue-chip company. It's KT&G's firm commitment to produce a sustainable management result in the areas of economy, environment and society by 2015.



## 'EVER-KT&G 2015', its Strategical Tasks and Expected Effectiveness

### Vision for Sustainable Business Management Strategy System



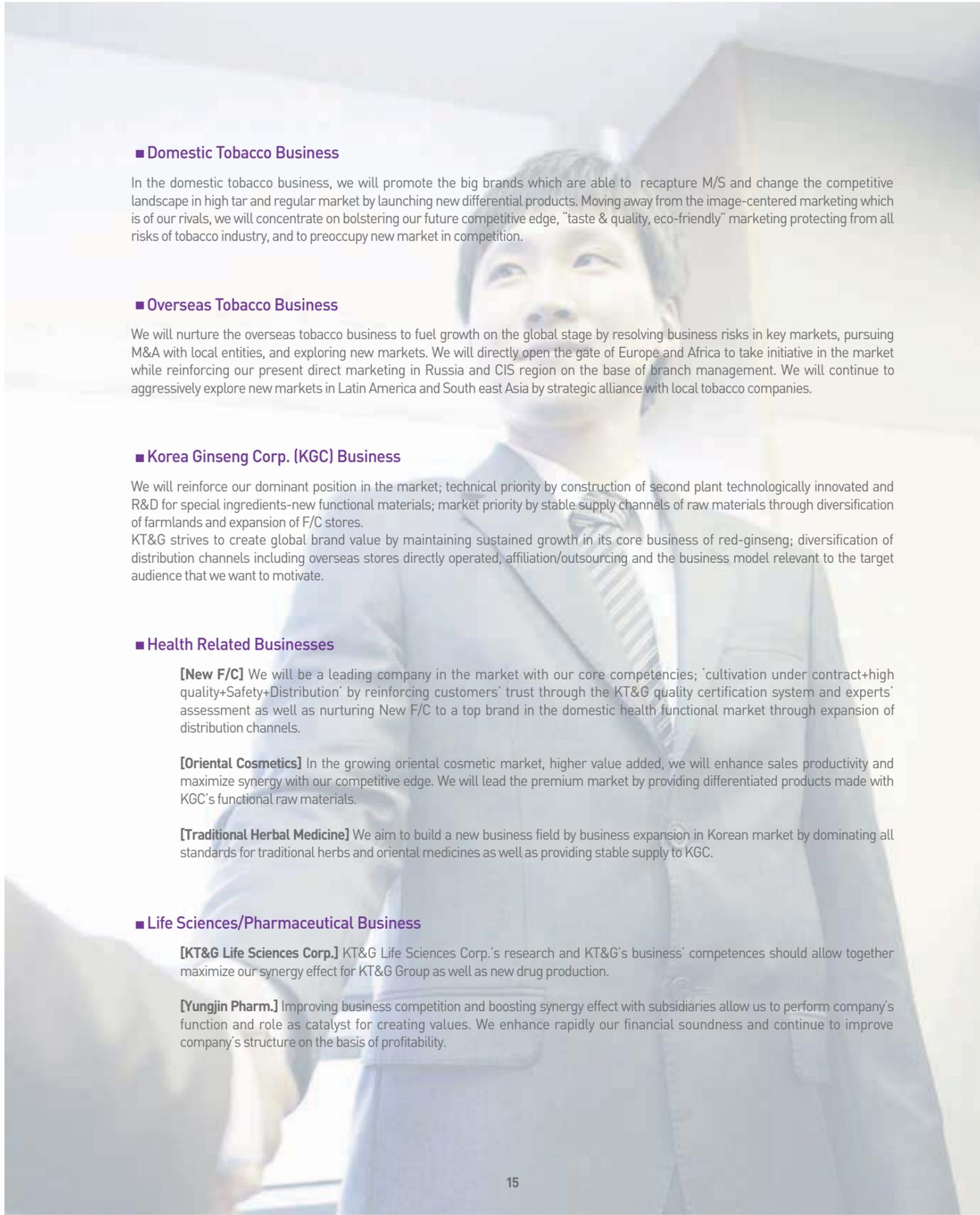
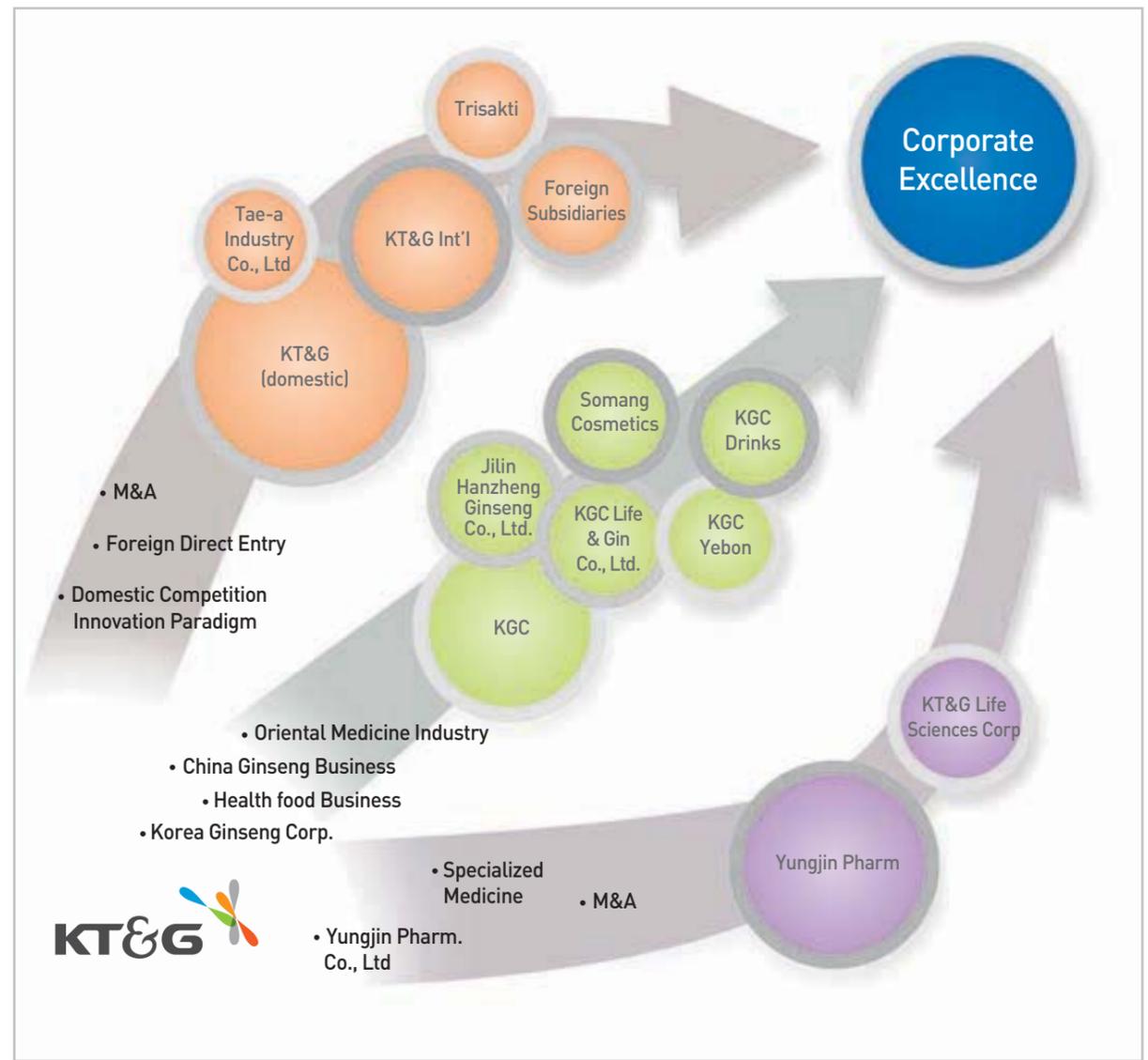
Strategic direction	Enhance business competitiveness through value-oriented reform	Improve win-win partnerships by fulfilling the role of corporate citizen	Build a green company by engaging in eco-friendly business activities
Strategic tasks	<ul style="list-style-type: none"> <li>Reinforce market competitiveness of core business</li> <li>Strengthen innovation leadership activities</li> <li>Improve corporate value through business diversification</li> </ul>	<ul style="list-style-type: none"> <li>Maximize customer value</li> <li>Maximize human resources value</li> <li>Reinforce win-win partnerships</li> </ul>	<ul style="list-style-type: none"> <li>Reinforce eco-friendly management system</li> <li>Strengthen readiness to respond to environmental risks</li> <li>Build eco-friendly corporate culture</li> </ul>
Actions	<ul style="list-style-type: none"> <li>Explore and select overseas markets</li> <li>Reinforce competitiveness in the domestic market</li> <li>Build infrastructure for sustainability management</li> <li>Develop domestic and overseas network for sustainability management</li> <li>Link with mid-to long-term master plan</li> <li>Foster global leaders and experts</li> <li>Maintain value-oriented business portfolio</li> <li>Secure competencies for new</li> </ul>	<ul style="list-style-type: none"> <li>Effectively enhance customer satisfaction</li> <li>Reinforce employee welfare benefits</li> <li>Strengthen link between performance and compensation</li> <li>Boost health and safety system</li> <li>Reinforce stakeholders' human network management</li> <li>Overseas sustainability of the supply chain</li> <li>Strengthen social contribution activities</li> <li>Establish and announce business philosophy</li> <li>Identify and respond to regulatory trends</li> </ul>	<ul style="list-style-type: none"> <li>Reinforce eco-friendly management organization</li> <li>Introduce and operate environmental management programs</li> <li>Conduct systematic environmental training</li> <li>Introduce and boost eco-efficiency of products</li> <li>Increase green purchasing</li> <li>Bolster climate change response system</li> <li>Reinforce external environmental communication</li> <li>Implement systematic environmental training</li> </ul>

# KT&G Medium and Long Term Business Strategy

We will maximize profitability by continuing to extend M/S in the domestic tobacco business and create synergy effect by sustaining growth via expansion in the overseas. As a company of general health care, we will foster topline growth and market expansion by maximizing synergy effect among KGC and other subsidiaries.

**Management Philosophy & Business Philosophy:** Align our business vision, corporate image, brand, management system and management and business philosophy; "Achievement of better life" for customers, shareholders, society and employees through products and services based on trust.

KT&G aims to be a global blue-chip company by maximizing corporate value, constructing a balanced business portfolio encompassing top domestic tobacco business and its overseas business in expansion as well as world brand red-ginseng with health and functional foods and bio-pharmaceutical business.



## ■ Domestic Tobacco Business

In the domestic tobacco business, we will promote the big brands which are able to recapture M/S and change the competitive landscape in high tar and regular market by launching new differential products. Moving away from the image-centered marketing which is of our rivals, we will concentrate on bolstering our future competitive edge, "taste & quality, eco-friendly" marketing protecting from all risks of tobacco industry, and to preoccupy new market in competition.

## ■ Overseas Tobacco Business

We will nurture the overseas tobacco business to fuel growth on the global stage by resolving business risks in key markets, pursuing M&A with local entities, and exploring new markets. We will directly open the gate of Europe and Africa to take initiative in the market while reinforcing our present direct marketing in Russia and CIS region on the base of branch management. We will continue to aggressively explore new markets in Latin America and South east Asia by strategic alliance with local tobacco companies.

## ■ Korea Ginseng Corp. (KGC) Business

We will reinforce our dominant position in the market; technical priority by construction of second plant technologically innovated and R&D for special ingredients-new functional materials; market priority by stable supply channels of raw materials through diversification of farmlands and expansion of F/C stores. KT&G strives to create global brand value by maintaining sustained growth in its core business of red-ginseng; diversification of distribution channels including overseas stores directly operated, affiliation/outourcing and the business model relevant to the target audience that we want to motivate.

## ■ Health Related Businesses

**[New F/C]** We will be a leading company in the market with our core competencies; 'cultivation under contract+high quality+Safety+Distribution' by reinforcing customers' trust through the KT&G quality certification system and experts' assessment as well as nurturing New F/C to a top brand in the domestic health functional market through expansion of distribution channels.

**[Oriental Cosmetics]** In the growing oriental cosmetic market, higher value added, we will enhance sales productivity and maximize synergy with our competitive edge. We will lead the premium market by providing differentiated products made with KGC's functional raw materials.

**[Traditional Herbal Medicine]** We aim to build a new business field by business expansion in Korean market by dominating all standards for traditional herbs and oriental medicines as well as providing stable supply to KGC.

## ■ Life Sciences/Pharmaceutical Business

**[KT&G Life Sciences Corp.]** KT&G Life Sciences Corp.'s research and KT&G's business' competences should allow together maximize our synergy effect for KT&G Group as well as new drug production.

**[Yungjin Pharm.]** Improving business competition and boosting synergy effect with subsidiaries allow us to perform company's function and role as catalyst for creating values. We enhance rapidly our financial soundness and continue to improve company's structure on the basis of profitability.

# Business Review & Global Business -Tobacco

ESSE, No. 1 National Brand Power for 3 Consecutive Years(2010-2012. NBCI)

KT&G, Creator of New Values

KT&G, Overseas Explorer for Growth and Profitability

## Greater Corporate Competitiveness

### Enhancing Brand Value

KT&G is focused on enhancing the asset value of each branch with the goal of building the number one tobacco brand in each segmented market. Our products, produced using quality ingredients and advanced automation, are constantly improved through diversification in terms of type, taste, price, and design to meet of consumers. To monitor overall brand performance in terms of competitiveness, satisfaction, recognition and image, our top brands undergo a Brand Equity Index review twice a year as well as a monthly brand index review. By adjusting our brand strategy in line with our sustainable strategy, KT&G updates its brand specific business plans and brand development and operational guidelines every year.

### Tobacco Brand Strategy for Differentiation

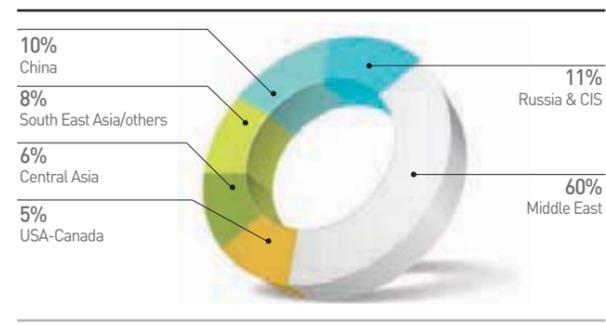


## Overseas Market Expansion

### Overseas Investment

KT&G exports about 70 types of brand to 49 countries, including the Middle East, Central Asia, and Russia. The company launches an active marketing campaign overseas for increasing its market share abroad and firmly establish itself as a global tobacco company. KT&G currently operates subsidiaries and branches in 6 countries-China, Indonesia, USA, Iran, Russia and Turkey. Its local plants in Iran, Russia and Turkey produce ESSE, PINE and other top KT&G brands for smooth supply to importing countries and adjacent countries. The company took over the Indonesian tobacco firm Trisakti through a global M&A investment.

### Overseas Sales by Region



Including overseas subsidiaries in 2011

## Participation in TFWA World Exhibition



Since 2006, KT&G has participated in the TFWA World Exhibition the largest exhibition of its kind to promote its brands, manage existing clients, enter new markets and secure new potential customers.

### World Class No.1 Brand ESSE

- 2.11 billion packs sold in 2011
- Top selling brand in world ultra-slim tobacco market in 2011
- Number one in brand power(K-BPI) for 5 consecutive years(2008-2012)
- Number one tobacco brand in NBCI(National Brand Competitiveness Index) for 3 consecutive years(2010-2012)



Korea Brand Power Index(K-BPI): The K-BPI measures a brand's power to influence customers' purchase behavior.

## Mutual Growth with the Affiliated Companies

- Ginseng, KGC Life & Gin, Yungjin Pharm, Somang Cosmetics

### Red-ginseng Business

We reinforce global sales activities and local marketing and are also focused on developing new health related businesses to pave the way for a promising future.

KOREA Ginseng Corporation(KGC)

KGC Life & Gin

### Health Related Businesses

We provide a total health solution to our customers by establishing a business model: new-concept health franchise, oriental herb-based cosmetics, functional foods and door-to-door sales.

### Cosmetic Business

We aim to create an high class red-ginseng oriental cosmetic market and increase our dominating power in the cosmetic markets by the synergy effect among R&D, producing know-how and distributional channels.

Somang Cosmetics

### Life Sciences-Pharmaceutical Business

Our future growth engine, the Life Sciences-pharmaceutical business, with R&D for the new medicines, is in the works of investment. Exportation of more than 30 percent of the turnover allow the company to expand its business into China, South East Asia and CIS markets.

Yungjin Pharm. Co., Ltd.

## Sales Presentation

### ■ Korea Ginseng Corporation(KGC)

KGC has inherited and developed the 'Cheongkwangjang's traditions from 1899, created by the Royal Interior of the Korean Empire. Growing as a general health company, KGC strengthens its leadership in the world ginseng market by globalization of this Korean great tradition.

1. Cheongkwangjang 2. Goodbase 3. Yebon



### ■ KGC Life & Gin

KGC Life & Gin provides a total health solution based on KGC's key competent system of controlling medicinal herbs.

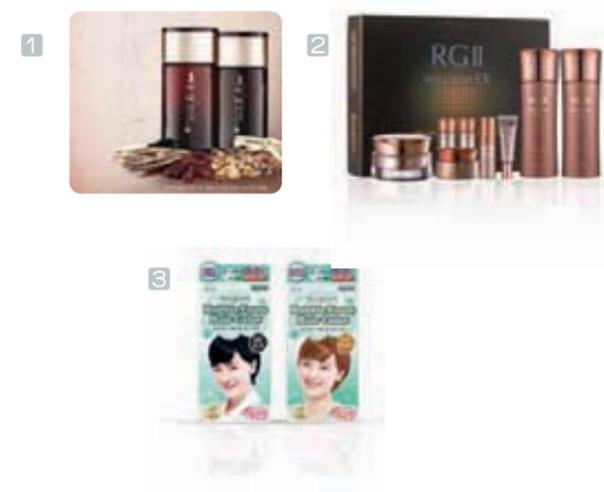
1. Boum: Living Oriental Medicine Store 2. Donginbi: Red ginseng Cosmetic 3. Eche: Door-to-door Sales



### ■ Somang Cosmetics

Somang Cosmetics, having launched outstanding brands like 'Man with Flower' and 'Danahan' oriental herb cosmetic, is improving the sales by developing reliable products and innovative strategies.

1. Danahan 2. RGI 3. Man with Flower



### ■ Yungjin Pharm. Co., Ltd.

With life sciences-pharmaceutical R&D pipeline, the Yungjin Pharm. distinguishes itself in the field of generic medicine and improves natural new drugs

1. Health drink 2. Health food 3. Medicine



## Product Liability and Competitiveness in Quality

### Production Research & Development

#### R&D Organization

The R&D Headquarters consists of the R&D Planning Office and 3 research centers. The R&D Planning Office draws up R&D strategies and goals and manages R&D projects to achieve the goals. The Production Research Center works on the development of new products and improvement of existing lines based on customer needs. The Technology Research Center conducts research on the technologies needed to develop innovation products and cultivate tobacco and enhance products. The Analysis Center focuses on the research of analysis technologies needed to develop products and technologies.



#### Intellectual Property Rights

KT&G owns patented technologies in various areas including product manufacturing technology, process technology and materials technology, which are directly and practically applied for product improvement and new product development.



## Tobacco in Turning-up

### Product Line-up

KT&G offers a product portfolio of diverse brands and prices that appeal to ever changing customer preferences. Backed by ongoing R&D and market surveys, we continue to unveil new products and enhance the quality of existing products through renewal launches, which in turn allows us to maximize customer satisfaction and elevate our status in the domestic and overseas markets. In addition to taste and flavor, product concept and design play a crucial role in meeting customers' demands. With this understanding, we provide a wide range of superior products with distinctive concepts and designs.

### Commitment to Quality & Eco Friendly Management

Pursuing to offer products of quality and to innovate divers technologies, KT&G practices eco-friendly management by minimizing pollutants and environmental effects.

### Our R&D Direction

1. Eco-friendly technology
2. Investigation to reduced pernicious ingredients
3. New Technology for Quality Improvement

### Products Line-up

#### ▶ ESSE series

Top selling super-slim tobacco brand both in the world market and in Korea.



#### ▶ BOHEM CIGAR series

Content of 30% premium cigar leaves to deliver the unique taste and flavor for sophisticated customers.



#### ▶ THIS PLUS series

For young people with confidence, passion and belief.



#### ▶ THE ONE series

Oxygenated filter of particles, double treated with oxygen. Neat and mild.



#### ▶ RAISON series

Projecting a young and creative air, it is made for meeting customers with a sense of 20s' generation.



#### ▶ ESSE SENSE

Super slim product, special filter applied firstly in Korea.



#### ▶ BOHEM CIGAR MOJITO DOUBLE

(Differentiated menthol technology & Menthol boosting technology)

Menthol cigarettes applied with Mojito cocktail flavor. Encapsulated flavor delivers much more refreshing feelings to different customers.



#### ▶ THE ONE ETIPAC

(Low sidestream smoke-reducing technology /Microcapsulation technology)

Considerate product for others. Reduced sidestream smoke and applied micro-capsule on packing paper to smell.



#### ▶ RAISON POP

(Flavor encapsulation technology)

Regular and menthol cigarettes in a single pack.



# Commitment for Global No.1 Brand

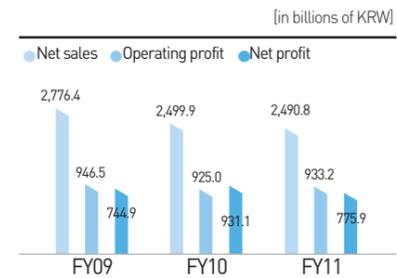
Top in the domestic market, KT&G exports as well about various types of brand to 49 countries, including the Middle East, Central Asia, and Russia. The company launches an active marketing campaign overseas for increasing its market share abroad and firmly establish itself as a global tobacco company.



## Operation Review

In 2011, under the trouble impacts of global economic crises triggered by various fiscal balance issues from advanced nations and of domestic market in the recession, KT&G has accomplished a great deal in turning around M/S by launching successfully new brands and responding effectively to price increase from its competitors. Due to the drop of domestic tobacco market, total net sales decreased by 0.4% to KRW2,490.8 billion compared with the previous year. However, operating profit increased by 0.9% to KRW933.2 billion through our effective cost control of production facilities and labor productivity. Net profit decreased by 16.7% to KRW775.9 billion compared to the previous year.

### Sales & Profit



We are going to look specifically each line of business performances for overcoming this business environmental uncertainty.

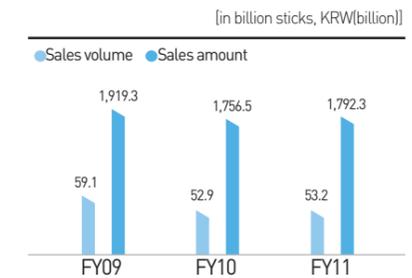
### Domestic Cigarette Business

Amid diversifying smokers' needs and intensifying competition with competitors' price hike in the domestic market, KT&G made various efforts to strengthen brand power in a response to this rapidly changing business environment. We maintained our edge in the ultra-slim segment with the ESSE Menthol 1mg and launched successfully in the regular and high-tar market Bohem Mojito, Korea first low sidestream smoke cigarette The One etipac and oxygen filtering The One impact which contains impact leaves.

For more effective sales execution, we put focus on managing integration: marketing, operation, production, raw materials and R&D. For greater efficiency and functionality we also carried out organizational restructuring for a role -model based autonomic management and introduced a new device to construct the SMART business activities.

In the result of our efforts, we achieved 100.4% of our sales volume compared with the previous year. On the profitability side, the sales proportion of Premium products rose by 2.0%p over the previous year, leading to a 1.6% boost in the net average selling price.

### Domestic Sales

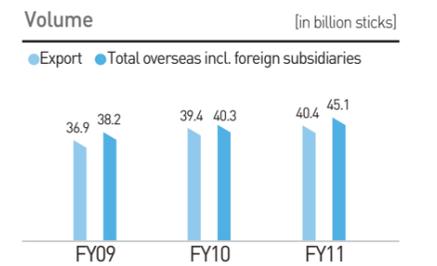


### Overseas Cigarette Business

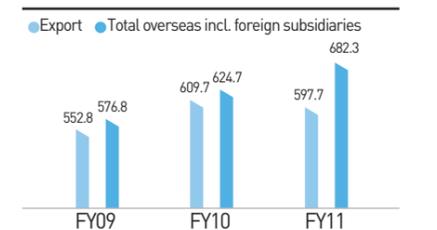
Overseas sales volume expanded by 2.6% to 40.4 billion sticks while export revenue decreased by 2.0% to KRW597.7 billion. Despite appreciation of the Korean currency, operating profit reached KRW172.2 billion. Under our marketing 4P strategy, we boosted advertising and promotional spending and expanded our distribution scope in key markets, namely the Middle East, Central Asia and CIS. We also pursued aggressive expansion in the Asia-Pacific market.

The overseas sale has highly increased due to Russian branch's start in 2011. Total overseas sale including exportation and results of foreign subsidiaries activities-Russia, Turkey, Iran, recorded export volume of 45.1 billion sticks, climbed by 12.0% over a year earlier. And the gross sales increased by 9.2 % to KRW682.3 billion over a year earlier.

### Overseas Sales



### Amount



To sustain growth of the overseas business, we pursued investment projects in regions with strong potential and are taking steps to foster the CIS and Russian market. The plans also include expansion of distribution channels in Southeast Asia, and entry into new markets in Europe, Africa and Latin America.

# Financial Review (Management Discussion & Analysis)

## Production and Procurement

We promote step by step to rationalize facilities operating in order to retain long-term competitiveness in production as well as the infra for high quality/high efficiency at the Sintanjin factory.

Its labor productivity rose by 8.1% and equipment overall efficiency improved by 1.6% compared with the previous year by reinforcing employees' competencies, mind innovation and outsourcing constantly low valued works. And we engaged in differentiated activities to promote eco-friendly policies; recycling of packing papers, construction of low-carbon green line(reuse of surplus energy) and to reinforce our corporate image by volunteer works for the society.

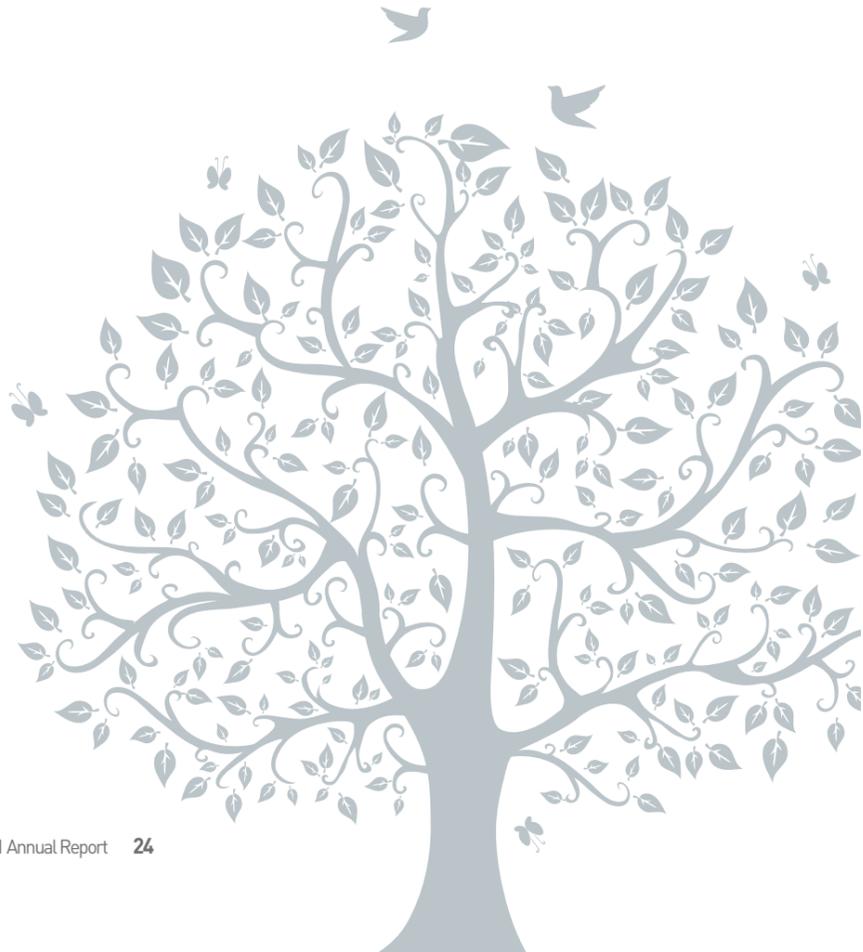
Thinking in customer's shoes, we introduced firstly in Korea a real-producer name inscription system for giving confidence to our customers, reinforced quality assurance activities with an emphasis on taste, and provided high quality products to them by rationalization of materials standard, quality innovation and activities reinforced to guarantee our tobaccos' taste.

In the raw materials and procurement sector, we took steps to identify factors that would enhance customer satisfaction. To meet consumers' needs, we procured tobacco leaves and raw materials of superior quality. We have a portfolio of supplier nations to keep pace with trends in the global tobacco leaf market. We also decreased the purchasing cost per unit and pursued steady supply-demand infra by local production projects and long-term supply contracts

We also maintained a stable supply plan for raw materials other than tobacco leaf; introduction of SQ system for sustainable supply competitiveness, promotion of Buying Power for integrative and cooperative purchase, bargaining power for purchase.

## Real-estate Business

In real-estate business, KT&G is working to retain its growth infra and constant profitability by maximizing company's property value. We have completed to construct and lease office buildings in two sites of Daechi-dong and Seodaemoo as one of the ways to maximize our idle properties' value. Remained vital to our company's strategy and infra construction, we pursued a property cleaning in the real-estate business: comprising new construction and remodeling, maintenance and divesting of real-estate holdings. In the lease business, which supports company's profitability and its growth infra, we recorded in this year KRW30.2 billion by increasing KRW5.8 billion over a year earlier.



KT&G's financial statements have been prepared based on the Korean International Financial Reporting Standards(K-IFRS), to fulfill the international standards of International Accounting Standards Board, as provided in the sentence 1 of paragraph (1) in Act on External Audit of Stock Companies' Article 13. The present information contains statements regarding the Company's financial conditions, operating performance and business purposes and plans. Such forward-looking statements involve known and unknown risks, uncertainties and other factors are not within control of the Company, which may cause the actual results or performance of the Company to be materially different from any anticipated future results or performance expressly stated or implied in the statements. KT&G does not assume responsibility on the accuracy or completeness of information contained or implied in this section, and statements on the past and future cannot be construed as the Company's promise or claims. The information herein is based on the Company's plans, estimations and projections as well as numerous assumptions considering the political and economic environment in Korea and other countries in which the Company currently operates or will operate in the future. Such estimations and projections can be altered due to the operating environment. Therefore, readers of this report should take reasonable care when relying on the information contained herein. Estimations, plans and projections are based on conditions as of the day this report was prepared. KT&G does not bear responsibility of providing additional information on future events. The term 'Company' used herein without any other qualifying description refers to 'KT&G'.

## Executive Summary

Global financial crisis coupled with intensified competition of domestic tobacco market and weak consumer sentiment in 2011 has created an unfavorable business climate. Against this backdrop, KT&G has done its best; it recorded sales of KRW2,490.8 billion from tobacco business, real estate business and etc., similar result compared with the previous year. The gross profit was up 1.7% thanks to the reduction of COGS. The operating profit was up 0.9% year-on-year at KRW933.2 billion, and the net profit decreased by 16.7% to KRW775.9 billion.

## Summarized Income Statement

	[in billions of KRW]			
	FY09	FY10	FY11	% YoY
Net sales	2,776	2,500	2,491	(0.4)
Gross profit	1,662	1,498	1,524	1.7
Operating profit	947	925	933	0.9
Net profit	745	931	776	(16.7)
<hr/>				
Total assets	4,788	5,254	5,418	3.1
Total Liabilities	935	916	874	(4.6)
Total shareholders' equity	3,853	4,338	4,544	4.7
<hr/>				
Gross profit margin(%)	58.4	59.9	61.2	1.3%p
Operating profit margin(%)	34.1	37.0	37.5	0.5%p
Net profit margin(%)	26.8	37.2	31.2	(6.0%p)
<hr/>				
EPS(KRW)	5,803	7,317	6,134	(16.2)
PER(X)	11.1	8.8	13.3	-
Stock Price(Year-end)(KRW)	64,400	64,700	81,400	25.8

## Operating Result Analysis

### Summarized Income Statement

	[in billions of KRW]		
	FY09	FY10	FY11
Net Sales	2,776	2,500	2,491
Gross profit	1,622	1,498	1,524
Operating profit	947	925	933
Net profit	745	931	776

Sales decreased by 0.4% year-on-year to KRW2,490.8 billion in 2011 but gross profit margin and operating profit margin improved by 1.3%p and 0.5%p respectively, compared to 2010. These achievements were realized due to our multilateral efforts in our Sintanjin plant.: strengthening reinforcement of long and mid term product competitiveness, securing product base for high quality and efficiency, and rationally strengthening equipment.

## Domestic Market share



By continually releasing strategically differentiated and high-valued new products and carrying out innovative marketing activities, KT&G firmly maintains its position as the leader in the market by recording 59% market share, increased 0.5%p this year over the last.

## Operating Revenues

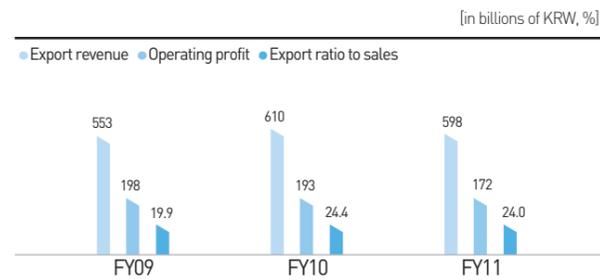
### Net ASP Per Pack & Premium Brand Ratio

	[%]		
	FY09	FY10	FY11
Net ASP per pack(KRW)	650.0	663.8	674.4
Premium brand sales volume(billion sticks)	41.4	37.9	39.2
Premium brand sales ratio to domestic sales	70.1	71.6	73.6

premium brand retail price : KRW2,500/pack and above

We are pursuing a reinforcement of each brands' property value by breaking down tobacco market in response to consumers' preference and creating new premium brands. Based on high-quality materials and technical automation, premium brands are fully meeting consumer's needs regarding tastes, price, and design. The key factor in enhancing profitability at KT&G is steadily growing product sales, especially those of value-added premium brands. The proportion of sales of premium brands to total sales has steadily increased and it has become core factor in profitability of KT&G.

### Exports

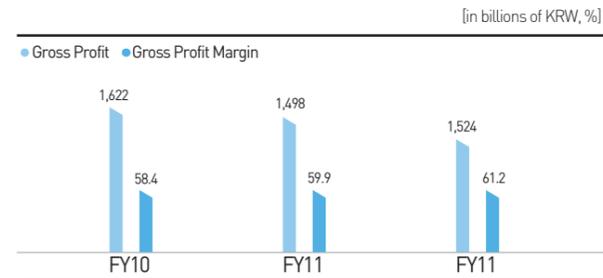


Thanks to the expansion of investment and distribution channels in the Middle East, Central Asia and CIS as well as expansion of volumes in the Asia-Pacific market, export revenue recorded KRW597.7 billion in spite of the appreciation of KRW.

The reason why total sales edged down can be explained by the accounting change that the result of Russian subsidiary, which had been disclosed in the existing exportation record, started to be accounted in the record of affiliated companies from 2011. Total overseas sales, including exportation and results of foreign subsidiaries' activities, increased by 9.2% to KRW682.3 billion over a year earlier.

## Operating Profitability

### Gross Profit



Due to the cost reduction through labor productivity and improvement of equipments efficiency, KT&G's gross profit in 2011 increased by 1.7% to KRW1,523.9 billion. The gross profit margin improved by 1.3%p to 61.2% compared to the previous year. It proves that KT&G shows healthy growth.

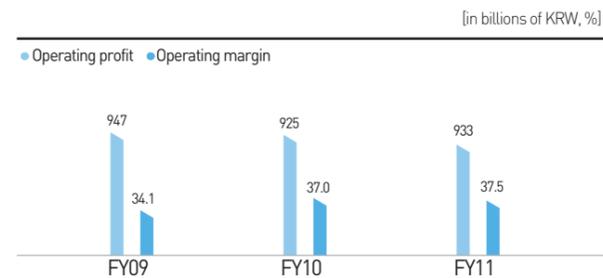
### Operating Expenses Breakdown

[in billions of KRW, %]

	FY09	FY10	FY11	% YOY
Operating expenses	675	573	591	3.1
Other income	(51)	(130)	(98)	(25.1)
SG&A expenses	611	631	626	(0.8)
Employee welfare fund	10	10	0	-
Other expenses	105	62	62	(0.1)

SG&A expenses decreased by 0.8% yoy. However, a big drop in gains from the disposal of tangible assets reduced other income by 25.1% in 2011. Therefore, operating expenses increased by 3.1% to KRW590.6 billion.

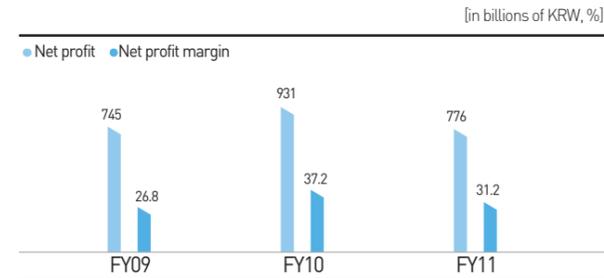
### Operating Profit



Operating profit increased by 0.8% yoy to KRW933.2 billion. With the improvement of COGS ratio the operating profit margin increased by 0.5%p to 37.5%.

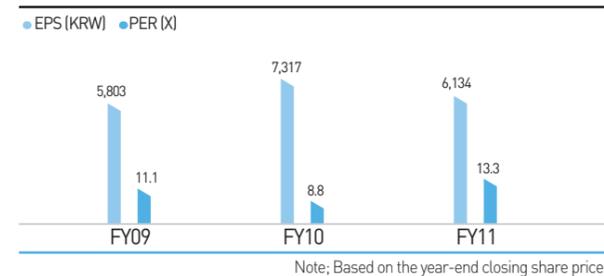
## Earnings and Dividends

### Net Income



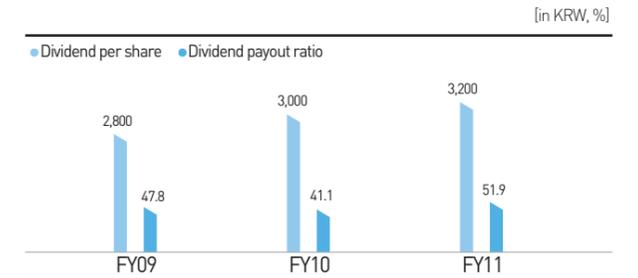
Although operating profit increased by 0.9% relative to 2010, net profit decreased by 16.7% to KRW775.9 billion due to the decrease of disposal gain of available-for-sale financial assets.

### EPS & PER



Earnings per share decreased by 16.2% compared with the previous year but the year-end closing share price inched up to KRW81,400 increased 25.8% in 2011. Consequently, the price-earnings ratio jumped from 8.8 to 13.3. KT&G's profit is expected to improve going forward.

### Dividend Per Share & Dividend Payout Ratio



KT&G did its best for maximizing corporate value and with a friendly attitude returning the value to the shareholders. For 2011, KT&G paid out a dividend of KRW3,200 per share, up by KRW200 from the previous year. The dividend translates to a payout ratio of 51.9%. Based on the year-end closing share price of KRW81,400 the dividend yield was 3.93%. KT&G will maintain a high dividend policy to maximize shareholder value going forward.

## Financial Condition Analysis

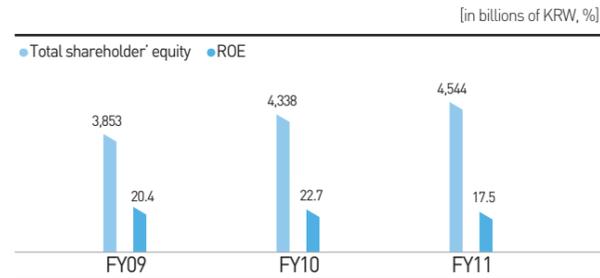
### Summarized Statements of Financial Position

[in billions of KRW, %]

	FY09	FY10	FY11	% YOY
Total assets	4,788	5,254	5,418	3.1
Total liabilities	935	916	874	(4.6)
Total shareholders' equity	3,853	4,338	4,544	4.7

Total assets increased by 3.1% to KRW5,417.5 billion in 2011. On the other hand, total liabilities decreased by 4.6% to KRW874.0 billion. Total liabilities have been steadily declining since 2008, underpinned by a healthy financial structure. A boost in retained earnings backed by robust net profit growth and effective management of reserves pushed up total shareholders' equity by 4.7% to KRW4,543.5 billion.

## Return on Equity



Total shareholders' equity grew by 4.7% while net profit decreased 16.7%. Accordingly, return on equity declined by 5.2%p to 17.5% compared with the previous year.

## Cash Flow Analysis

### Summarized Statement of Cash Flow

[in billions of KRW, %]

	FY09	FY10	FY11
Cash Flow from Operating Activities	748	715	662
Cash Flow from Investing Activities	(102)	173	(351)
Cash Flow from Financing Activities	(465)	(329)	(500)
Net increase(decrease) in cash and cash equivalents	181	560	(190)
Cash & cash equivalents at the end of year	269	829	639

Despite growth in gross and operating profit in 2011, a reduction in working capital slightly lowered net cash flow from operating activities. Cash and cash equivalents increased by making bold facility investments to enhance product competitiveness, and making diverse efforts to cultivate future growth drivers. At the end of 2011, the cash and cash equivalents decreased from KRW829.0 billion to KRW639.1 billion, down by 22.9% over a year earlier.



## 2012 Business Plan & Outlook

The business is expected to be more volatile, due to deeper contractions of business conditions in 2012: financial crises in Europe warning a world economic recession, troubles in North Korea and volatilities of economic indicators. In the tobacco market, total demand would decrease slightly due to smoking regulation and social trend of anti-smoking.

### We will carefully prepare the future by setting clear business goals without vacillation, leaping in each business vision, and executing "Forward-looking and long-run business principle"

We will aggressively pursue market expansion and create new business growth engines. Reinforcing the top leadership in our key domestic markets of tobacco and ginseng, we will widely and rapidly penetrate in the global market. We will also pursue general health care and bio business by maximizing our group's competence and synergy. Constructing a balanced business portfolio, KT&G will surely jump up to an excellent global company encompassing both growth and profitability.

### We will continue our upward movement of M/S in the domestic tobacco business

In the domestic tobacco business, we will succeed in the high tar market by promoting big brand competitiveness and launching differentiated products. KT&G concentrates to bolster taste-quality-ecology centered marketing image to change market rules and communicate with consumers. We will also reinforce our business competence by strengthening capabilities of sales forces.

### We will pursue constant and high growth by exploring new markets

We will take initiative in key markets, extend direct-distribution coverage, and differentiate marketings by area in the new market. We will also secure footholds in the overseas market. Trisakti, bridgehead in the south-east Asia, will reinforce its position by aggressive marketing.

### We will lead the red ginseng market by reinforcing the premium position of differentiated technology and image

We will take an initiative in the domestic market through a broader high quality brand line-up and brand portfolio by series. We will continue to produce highly functional products, reinforce technical priority by second plant construction, and promote a premium image of Cheong-Kwan-Jang in the market. In the overseas market, we will reinforce direct operation base and strive to get onto the right track in Jilin Hanjung Co. Ltd. by achieving rapid development of products and timely completion of plant.

### We will produce meaningful results in health related business with our core competence and maximize synergy effects

Related to the health business, we will make our new F/C to be a dark horse in the market through readjustment of brand recognition and expansion of distribution channels. The door-to-door sales will rapidly grow due to differentiated marketing network and promotion of strategic brands. Oriental herb-based cosmetics will be able to jump up as a major player in the market by reinforcing viability and continuing to extend market through association with KT&G group's activities.

### We will reinforce efficient operation for properties and prepare a stable growth infrastructure

We will improve profitability of the group by maximizing real-estate holding value and selectively investing in good properties. And we will implement a financial strategy supporting the group to invest in equilibrium and return the profit to stakeholders.

Seeds of Imagination  
Turn into **KT&G**



**Creativity and Innovation Lead**

**Balancing on the Growth**

**Management Standard**

- Awarded Best Company for Corporate Governance Structure in 2011.
- Customer Satisfaction

**Ethical management, Transparent Management & KT&G**

**Environmental Standard**

- Environmental Care

**KT&G Environment-Friendly Management Institution**

- Strengthened Management in Energy Consumption and Greenhouse Emissions
- KT&G Eco-Friendly Management Road Map
- Strengthened External Communication
- Participation in Carbon Disclosure Project(CDP)
- ISO 14001 Certification

**Social Standard**

- Contribution to Arts and Culture
- Talent Sharing Activities-Sangsang Together, Sangsang Volunteer, Sangsang Univ.



# Management Standard

Led by BOD, a supreme organization for decision, KT&G has settled and advanced decision-making and shareholder-oriented management for management accountability, transparent information disclosure and trust improvement. Most exemplary corporate governance in Korea.

## Awarded Best Company for Corporate Governance Structure in 2011.

### Structure and Functions of BOD

KT&G is working to establish an efficient corporate governance structure through an accountable professional management system, led by an independent board of directors, and transparent disclosure of information. Consisting of nine outside directors and one executive director, our board of directors is rated the best in the nation in terms of activity and efficiency in operations. For transparency of business management, KT&G separated the role of the chair of the board from that of the CEO in March 2010. The qualification of outside director candidates is reviewed through the Outside Director Candidate Recommendation Committee, and the most qualified candidates whose independence and expertise are verified are recommended to the general meeting of shareholders for appointment.

### Committees Inside of The BOD

KT&G ensures reasonable and prompt decisions by establishing, inside the Board of Directors, the Strategy Committee, the Audit Committee, and Evaluation & Compensation Committee, and the Investment Committee, which are designed to enhance the expertise and transparency of the board of directors and establish a stable governance structure. In particular, all members of the Audit Committee and the Evaluation & Compensation Committee are comprised of outside directors to enhance the transparency and credibility of financial information and ensure that the management is properly supervised and supported.

### Committees' Key Functions and Decisions

Committee	Key Functions	Decisions
Board of Directors		
Strategy Committee	Deliberates on business management strategies and corporate governance structure	01. Calling general meetings of shareholders and developing agenda
Investment Committee	Manages investments, social contribution, risks and other requirements under the Commercial Act	02. Issues related to finance
Evaluation & Compensation Committee	Evaluates employee performance and determines compensation	03. Issues related to key business decisions
Audit Committee	Reviews feasibility of finance & accounting, assesses internal control system	04. Other issues recognized by the board, issues requiring decision by the board by law and by articles of incorporation

### KT&G, Excellent Company of Transparent and Systemic Corporate Structure Based on BOD's Training, Evaluation and General Shareholders' Meeting.

Outside directors are provided with swift and accurate access to training opportunities and information as necessary, comprising issue briefing on management actualities of the company, to carry out their duties. BOD and each committee are in self-evaluation and mutual evaluation every year. The outcome of the review is reported, with specialist aid if necessary, in a brief summary through BOD and the committees every January of the year.

### Performance Evaluation by The BOD

The Board of Directors' meeting was held 11 times in 2011. At the end of every year, the board and its committees conduct a general evaluation of the company's performance over the year as well as cross-evaluations by individual members. The evaluation results are analyzed and reported in the beginning of the following year.

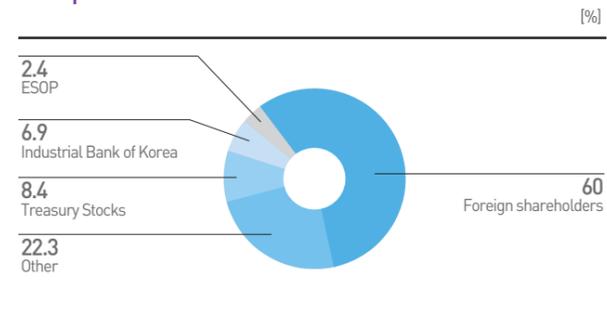
### Maximizing Shareholder Value

Based on its accumulated achievements and competence, KT&G grew to be the world's fifth largest tobacco company. We are maximizing shareholder value by raising our business value through a balanced portfolio across several business sectors. In particular, our company has applied International Financial Reporting Standards(IFRS) since 2009 and disclosed financial statements that include the financial performance of our affiliates.

### Investor Relations

At KT&G, Investor Relations(IR) activities are recognized as a two-way communication with investors and a process to enhance corporate value. Based on such recognition, we regularly organize IR sessions, road shows, conferences, forums, and individual IR sessions with our analysts and investors to keep a smooth and active communication going with our shareholders and investors. We continue to expand the scope of our investor relations by participating in IR conferences in New York, London, Japan, Hong Kong, Singapore as well as Korea.

### Composition of Shareholders



### Key IR Activities



## Customer Satisfaction

### Enhanced Customer Consultation Process

The value of a company comes from its customers. To go beyond customer satisfaction and touch the hearts of its customers, KT&G is always open to customer opinions and engage in various policies and activities.

Our cigarette packages come with the phone number of our CS-Center(080-931-0399), which is open 24 hours a day. The CS-Center is a 'customer happiness network' that promptly receives customer complaints and problems and handles them fairly and accurately.

Our customer counseling system is divided into general counseling about 'health, tobacco policy, marketing, and general matters relating to the company' and product claims concerning 'cigarettes, packaging, taste and aroma, and other inconveniences experienced during smoking.' All claims are handled through the CS-Center. Our systematic customer counseling system aims to satisfy customers through prompt claims handling. Feedback on process is communicated to the Quality Management Office to further improve product quality.

### Reflecting Customer Opinions

The CS-Center handles all types of customer claims, including opinions received by phone or online as well as complaints received through our retail networks. The CS-Center prepares daily and monthly reports, which are shared with brand managers. The center also regularly discusses problems, solutions, and quality enhancement with brand managers through meetings and education programs.

Product claims are mostly related to cigarettes, packaging, taste and aroma, which are largely subjective issues. Despite installing detectors on the upper part of cigarette packages, frequent claims were received on defective side packaging. To solve this problem, the company installed defective package detectors, successfully reducing customer discontent. The result of claims handling is entered into the claims handling management log and reported to the Marketing Division.

### Customer Communication Channels

#### Website

KT&G regularly updates its Frequently Asked Questions section on its website so that customers can conveniently find the information they need on brand, product, quality and other company-related issues. Any questions not found on the FAQ can be sent to us directly by calling our customer center or sending an e-mail through the Q&A section on our website. The results can be checked via our website or by e-mail.

#### Sinmungo

To fulfill its business management philosophy of 'companionship' KT&G operates the Sinmungo system. All personal information collected through the Sinmungo or customer center are strictly protected in accordance with the Personal Information Protection Guidelines.

## Ethical Management, Transparent Management & KT&G

KT&G in 2001, Establishment of Ethical Management System

KT&G in 2006, Grand Prize in 'The 4th Korea Ethical Management Awards'

KT&G in 2008, 2009, Transparent Management of Unfair Trade Zero

KT&G in 2010 ~11. Establishment of Supplier Authentication Manual, a Guideline for Fair Trade

KT&G in 2012 ~13 Fair Trade Agreement and Reinforcement of Ethical Management

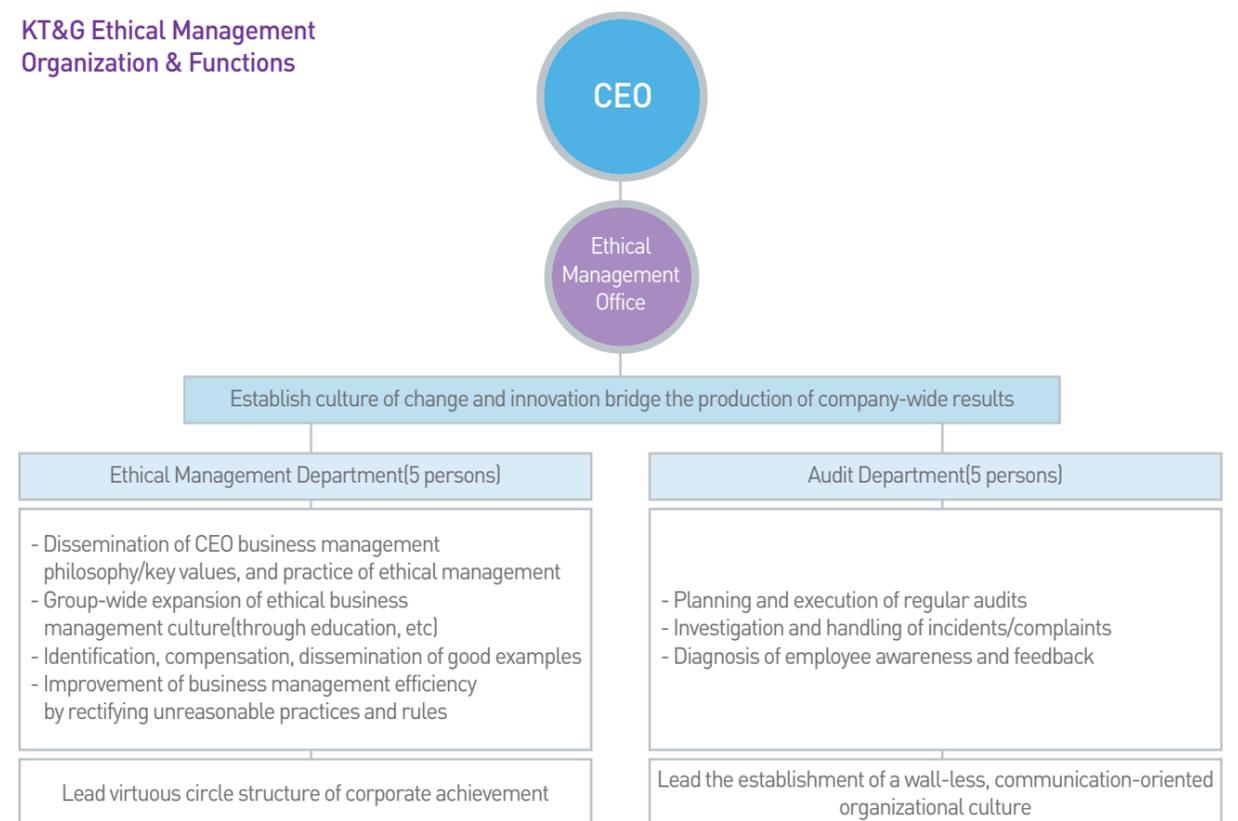
KT&G was able to be recognized as a world company by enhancing transparent and systematically functioned corporate governance. Having established since 2001 the ethical management system comprising ethical standards, ethics code for directors and guidelines, KT&G is actively promoting transparent and ethical management by the system based on ethical management guidelines established by area, business ethics charter, ethics code for directors, Compliance Program, and customer service code. Particularly, there was not a single unfair trade case in 2008 and 2009 thanks to our faithful execution of the Compliance Program to establish CP's core seven elements and the public announcement of materials related to Korean Exchange(KRX).

KT&G, serving as a role model of fair company, shows the way to execute ethical management of cooperation like; companies and society go together in the relation organized with customers, society, environment, market, staffs & employees, collaborated companies and shareholders.

No longer simply remained to establish and operate ethical management system; the audit office of KT&G carried out post evaluation at the same time. As a result, KT&G was awarded the overall grand prize in the 4th Korea Ethical Management Grand Prize in 2006. In order to maintain its reputation as a company of transparency and righteousness, KT&G shares ethical activities at corporate level in order to increase the members' ethics of the company and innovate corporate image.

Furthermore, KT&G induces its collaborating companies to improve human right and solve labor problem, anti-corruption and ecological issues.

### KT&G Ethical Management Organization & Functions





### Evolution of Ethical Management

KT&G developed cyber ethical management program and ethical management practical courses to carry out ethics education, based on real and situational cases. Started from 2007, our cyber ethical program has been continuing for new employees every year without interruption. In 2011, KT&G focused on enhancing the ethical culture of business and the corporate image. To this end, information on unethical behavior, abnormal sales behavior and other information related to ethical business was shared company-wide, while education on ethical business management was conducted as needed during on-site visits. In 2012, the ethical business practices of our major affiliated companies will be diagnosed for improvement where needed. This will allow the group to set the right directions and reinforce the practice of ethical business management.

Reminding that employees are subject to producing corporate value, it is necessary to initiate policies to 'maximize manpower' to produce global leaders and specialists

KT&G pursues work-life balance as a top priority to make sure that employees lead a stable life as they are the company's biggest asset and source of competitiveness. To this end, we offer various welfare benefits for our workers.

### Strategic HR Development

KT&G is striving to foster personal competence of all its employees by establishing missions for HR development, which is aligned with KT&G's key values and talent criteria, and achieving goals with strategies and key tasks. In March 2011, KT&G built BIS(Business Information Service), which offers web- and smart phone-based video contents about the economy, business management, and leadership, as well as services for searching papers/dissertation. The KISS Education Management System helps employees to track their education history, manage their career development, and share useful information others offered in group education.



### Fair Evaluation System

In accordance with internal regulations, all employees undergo a standardized evaluation process. The evaluation is designed to periodically measure and diagnose the performance and competence of each individual employee and reward those with outstanding performance results through fair performance management and competence development. We are working to establish a reward system of internal fairness and external competitiveness. The new employees receive a pay level that is 206% of that of the legal minimum pay. There is no difference in the basic pay level between men and women in the same position and each individual is rewarded on the basis of his/her capacity.

### Hiring of Global Talents

Based on Labor Standard Acts, KT&G offers equal opportunity to all including people of merits and disabled, without discrimination of region, gender, or religion. KT&G selects people who are committed to challenges, execution, and mutual cooperation with the spirit of 'I am C.E.O.'

### Win-win Structure in Labor-Management Culture

KT&G developed mid-to long term welfare programs in consideration of improving employees' quality of life and maximizing corporate value. The company offers all employees; child care allowance, preschool expense, junior high school and high school expense, university scholarship, expense for athletic meet, congratulatory/condolence money, condolence payment for accident, housing loan, medical check-up, medical benefits, recreational facilities etc. In welfare programs, all employees receive same benefits without distinction between full-time workers and part-timers. We introduced an employee stock ownership plan to strengthen trust and cooperation between management and labor. The satisfaction for our selective welfare program is increasing thanks to its various programs and benefits.

### Employee Welfare Programs

KT&G pursues work-life balance to make sure that its employees lead a stable life because they are the company's biggest asset and source of competitiveness. We develop welfare programs in consideration of employees' life cycle based on their age and seniority. Our various programs benefit not only employees but also their families to enjoy a higher quality of life.

### Retirement Pension

KT&G operates a retirement pension program to assist employees lead a stable life after retiring and protect their rights to retirement pension. All employees can opt between Defined Benefit(DB) or Defined Contribution(DC) depending on their personal preference and disposition.

### Educational Support

The high cost of bringing up and educating a child is pointed out as one of the causes behind the issue of low-birth rate and aging society, a phenomena that is becoming more and more widespread in Korea. To address the social problem facing the nation, KT&G is working to reduce the financial burden of its employees by offering child tuition assistance and coverage of all educational expenses from elementary school up to college. Employees are also given the opportunity to develop themselves through cyber education, reading support, vocational training, and E-MBA programs.

### Leisure/Vacation Support

KT&G actively encourages its employees' leisure activities to create a healthy and vibrant organizational culture. We operate company condominium, pension, and other types of recreational facilities year round and offer employees an opportunity to recharge once every five years of continued service with refresh vacation and bonus. According to the legal labor standards, all pregnant employees are given 90 days of maternity leave. Male employees are given a three-day leave when their wife gives birth to a child. Employees with child aged six years or less can also benefit from a one-year parental leave.

### Stable Life

To help employees live a stable life, KT&G offers company housing to those coming from other regions. We also offer a long-term, low interest rate housing loan of up to 100 million won. All employees receive congratulatory/condolence money, optional welfare benefits, medical benefits, and condolence payment for accident. We operate an employee share ownership plan(ESOP) to strengthen trust and cooperation between management and labor.

## Environmental Standard

- Four Manufacturing Plants are Under Environmental Management after Acquisition of ISO 14001 Certification
- Materials Plant and Printing Depot, Certificated in 2008 and 2009
- Ranked No. 1 in ESG(Environment, Society, Corporate Governance) Evaluation

### Environmental Care

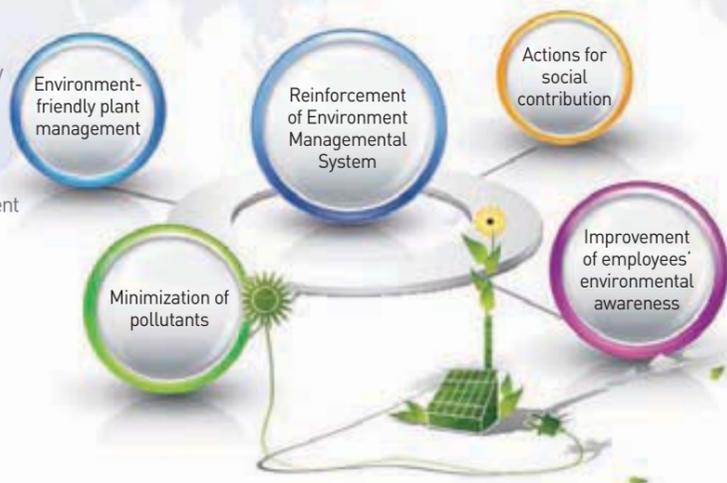
#### KT&G's Environment-friendly Business Management-strategy and Directions

KT&G considers environment-friendly business management to be the corporate's social responsibility and makes various efforts for an integrated and systematic response to environment and climate change issues rather than simply responding to regulatory requirements. To this end, KT&G strengthened the pollution material outputs management by overhauling its internal eco-friendly business management system. We are also dedicated to climate change issues in line with the government's low-carbon, green growth policy. KT&G's annual environment-related investment has reached to KRW1,600 million. The factory waste quantity decreased in 2011 remarkably by 63% from 2009, 4.54 million tons to 1.66 million tons.

### Environment Management System

#### Context

- Global issue of a strategy for response to climate change due to global warming
- Rise of meritocratic environment management for becoming a global blue-chip company
- Stress on environment quality and social responsibility for the fulfillment of obligations



#### Plan

- Improvement of environment-friendly management
- Establishment of environmental management strategies and road map
- Focus & choice of key environmental business
- Improvement of environment-friendly corporate image
- Review to systematization of functions and organizational reinforcement

KT&G is making various efforts to reduce waste generated during the manufacturing process. Using new technologies to reduce by-products in the manufacturing process, we cut down on the use of raw materials. The use of technologies to recycle raw materials separated from the manufacturing process helped us achieve a higher rate of recycling while enhancing product quality.

#### Environment Departments at Manufacturing Plants

KT&G has less environmental issues than other manufacturing businesses. That said, the environment departments at the plants are closely monitoring energy saving and environment-related issues, while focusing on a systematic management of pollution materials to make the plants eco-friendly. We are also working to upgrade our environment performance management through the newly installed Green Business Management Team in 2009.

which seeks to promote eco-friendly business management throughout the group, enhance environment management at the plants, and reduce green gas emissions.

#### Purposes of Environment-Friendly Management

KT&G considers environment-friendly management to be a corporate social responsibility and makes various efforts for an integrated and systematic response to environmental issues: environment-friendly plant management, minimization of pollutants, improvement of employees' environmental awareness, actions for social contribution. KT&G strives to become a global blue-chip company by executing its meritocratic business activities along with environment management strategy and road map through concrete ideas and activities. For these purposes, KT&G is reinforcing its performant power to settle an environment-friendly management by control management in the company-side while minimizing environmental risks in the plant areas.

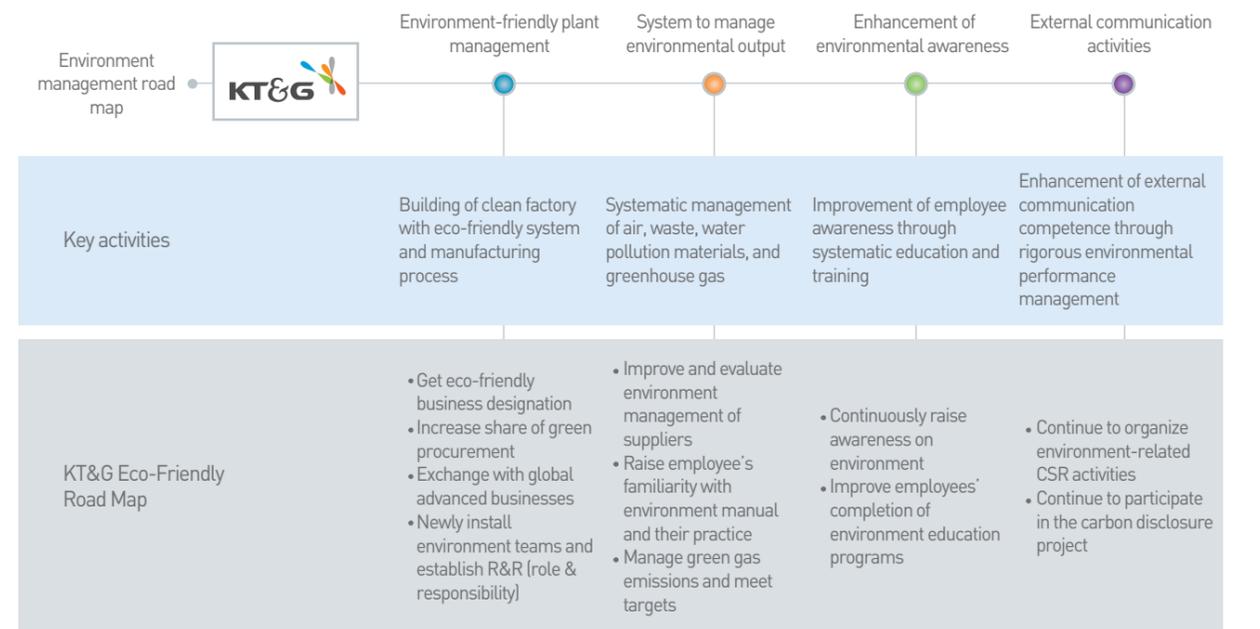
## KT&G Environment-Friendly Management Institution

### Strengthened Management in Energy Consumption and Greenhouse Emissions

With the 'greenhouse gas and energy target management system' placed in 2011, businesses are stepping up their activities to cope with climate change. Though no business subject to greenhouse gas or energy target management were designated by the government, KT&G periodically manages its energy consumption and greenhouse gas emissions and is engaged in various activities to reduce greenhouse gas emissions in order to proactively cope with climate change.

The KT&G Yeongju plant signed a cooperation agreement with the nearby Novelis Korea in July 2011 on joint energy use. This is an initiative to cope with climate change and achieve low-carbon, green growth. Through this agreement, KT&G will capture and use 2,700 tons of surplus steam generated by Novelis Korea, which will be transferred through a pipeline installed between the two plants. This will result in a reduction of 521 tons of CO2 a year. Thanks to these efforts, the Yeongju plant received the 'Best Energy-saving Business in Gyeongbuk 2011' award.

### KT&G Eco-Friendly Management Road Map



### Strengthened External Communication

KT&G is increasing its environmental investment to ensure that its plants do not cause issues of foul odor, waste water, or air pollutants in nearby areas.

In response to the change in urban classification, from an industrial area to a general residential area, of the area near the Cheonan plant, we invested 2 billion won to build an odor control facility and minimize disturbances to local residents. We are also involved in enlarging waste water treatment facilities and reinforcing dust collectors.

As part of our community involvement activities, we also periodically organize environment cleaning activities with local communities to strengthen our relationship with them.

KT&G operates tours to its three plants(Yeongju, Gwangju, Sintanjin), which boast the largest and best manufacturing facilities in Asia. Through the tours, we disclose to the public our manufacturing environment and eco-friendly facilities, which are in line with ISO international standards on quality and environmental management system.

### ISO 14001 Certification



KT&G obtained ISO 14001 certification for all of its manufacturing plants and built a foundation for eco-friendly business management.

### Participation in Carbon Disclosure Project(CDP)

The Carbon Disclosure Project(CDP) is a project to tackle climate change. It is currently carried out by more than 60 countries worldwide. As climate change issues emerge as an important consideration for investment decisions by external investment institutions, over 2,500 businesses around the world participate in CDP to reduce greenhouse gas emissions as well as disclose their carbon management strategies, which identify the risks and opportunities of climate change. KT&G has disclosed its greenhouse gas emissions reduction and related strategies through CDP response from 2010.



# Social standard

KT&G is supporting the promotion of non-mainstream arts and culture in various ways. We are also involving in volunteer activities to share the talents of our employees with others, while offering financial assistance to those in dire need.



## KT&G's Social Contribution Symbol

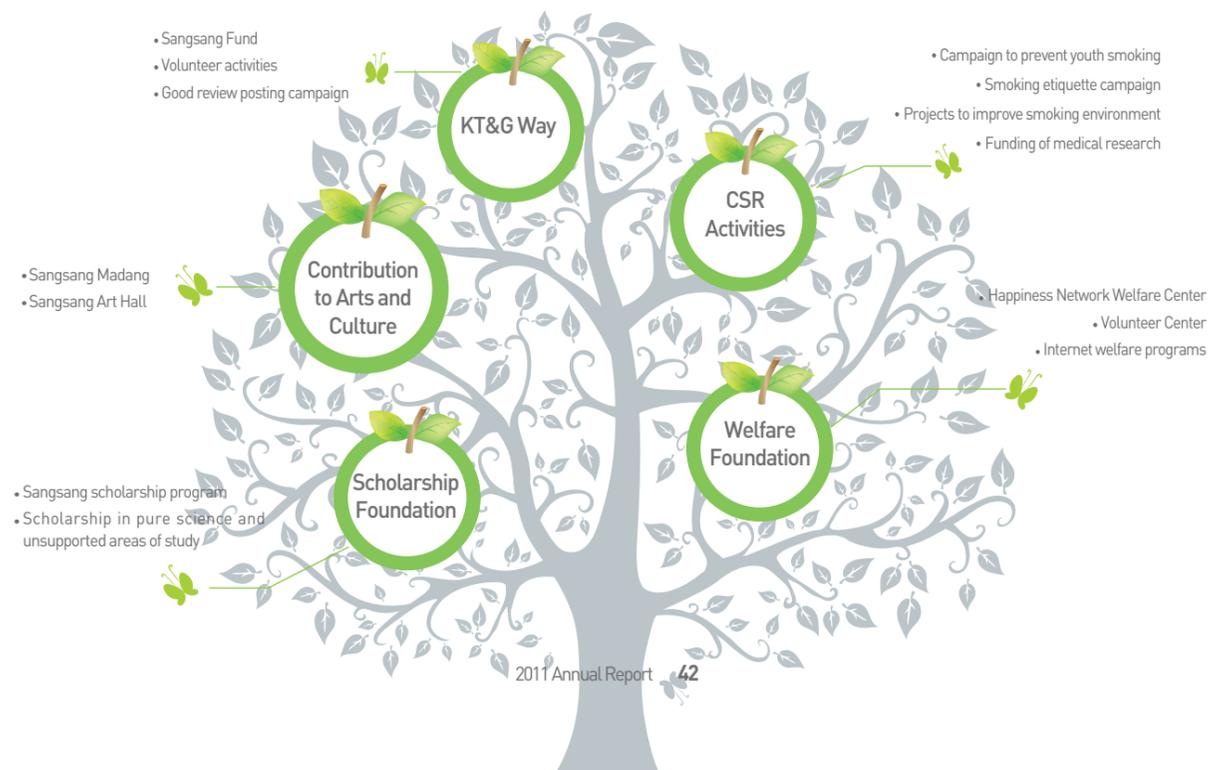
KT&G's social contribution symbol is a simple image in the shape of a man uphold a heart. It embodies the message of dream and hope and our imagination of a happy future full of love and sharing.

## KT&G Way

KT&G newly established its mid-to long-term social contribution directions by upgrading its existing social contribution activities. The 'KT&G Way' is based on a systematic development of the company's existing social contribution activities. It incorporates a differentiated social contribution method such as mecenat activities.

## KT&G's Social Contribution Direction

Based on the keyword 'Sangsang(imagination),' KT&G's social contribution direction is largely divided into five areas: the 'Contribution to arts and culture' to support and create new culture, the 'Welfare Foundation' to help disadvantaged groups of the society, the 'Scholarship Foundation' to offer financial assistance to creative talents of the global era, the 'Employee volunteer activities' to share our employees' talents with others, and the 'CSR activities' that reflect the characteristics of the industry.



## KT&G Welfare Foundation

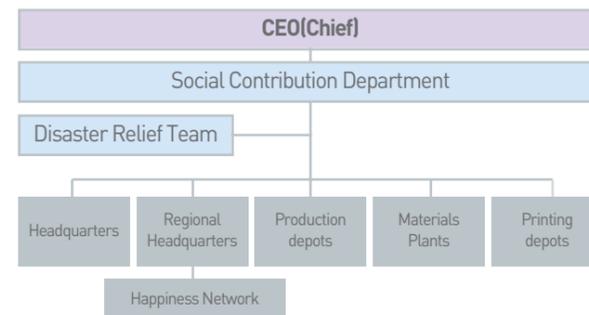
- Happiness Network Welfare Center: The center provides special services by supporting various facilities and organizations that contribute to the social welfare of disadvantaged people in the local communities.
- Internet welfare programs : KT&G Welfare Foundation is engaged in enhancing internet welfare program by supporting to raise money for child heads or guardians of families with low income.
- Social welfare supporting Activities: Under the 'Small car supporting program for social welfare centers', KT&G's has donated 100 small cars a year since 2004. A total of 600 cars was donated and became rapid foots to social workers and related persons in community welfare centers.

## Support for Disadvantaged-Volunteer Center, Welfare Foundation

KT&G Welfare Foundation supports various volunteer activities with youth and university volunteer clubs and senior volunteer groups that contribute to the social welfare of disadvantaged people in the local communities. To realize a 'tolerant society,' KT&G recognizes that community involvement activities are an integral part of its business management and undertakes social welfare and health care programs accordingly. We also engage in enhancing social welfare by supporting programs for treating dread diseases to achieve win-win situation between businesses and the society. In collaboration with welfare institutions and civil organizations in the communities, KT&G Welfare Foundation operates eight happiness network welfare centers around the nation.

## KT&G Employee Volunteer Group

KT&G tries to encourage employee's internal and external participation between the company and the community to settle a contribution culture in its organizations. KT&G's volunteer groups, 182 employee participating, help resolve local community problems by visiting social welfare centers and practicing volunteer activities for environment.



## Human Resources Cultivation for the Future KT&G Scholarship Foundation

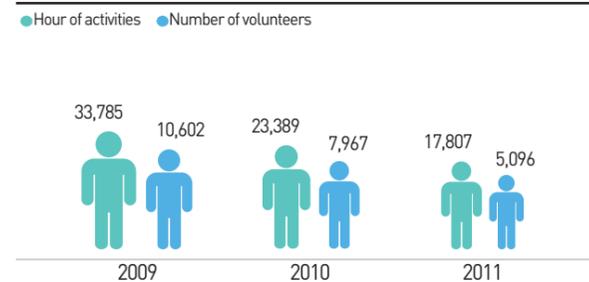
KT&G Scholarship Foundation presents a new vision for scholarship programs by offering a systematic and sustained talent fostering program. Its scholarship and research funding benefit young talents from Korea and abroad.

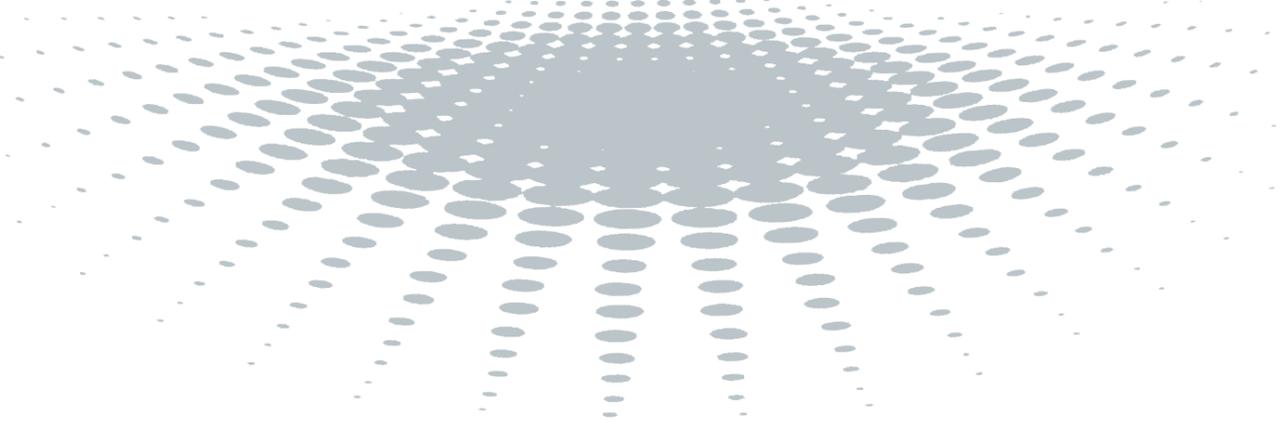
KT&G offers approximately 4 million won in annual financial aid to students of low-income families, multi-cultural families, and North Korean defector families to help provide fair chance in education. The financial aid is used to cover school fees, private institute fees, uniforms, and other costs related to learning.

KT&G offers scholarship to graduate students studying pure science, for which there is relatively less support compared to practical science. Those with a major in humanities benefit from tuition coverage while in a graduate and doctoral program. In addition to funding Korean graduate students studying in Korea, the company also offers financial aid to Korean students studying overseas to strengthen the international competitiveness of Korean talents and promote broad scientific exchange.

Young, outstanding foreign students enrolled in a Korean graduate school can benefit from financial aid from KT&G as well. The financial aid covers tuition and living expenses. We also offer them an opportunity to experience Korean culture. KT&G organized a humanities contest to identify tasks for the future of humanities and systematically organize research projects. This initiative is designed to encourage those majoring in the humanities to promote their studies and contribute to the development of academic research in this field. Lectures are offered to graduate students by the nation's top mentors. Various fields are covered and presented from the perspective of the humanities. Organized in major universities in Seoul every year, the lectures are designed to teach students various aspects of the humanities and help them develop a creative mind.

## Number and Activity Hour of Employee Volunteers





## Contribution to Arts and Culture

### Mecenat Activities

KT&G supports the development of arts and culture in every day life for all people, rather than arts and culture exclusively enjoyed by certain groups of people. Since joining the Korean Business Council for the Arts in 1994, KT&G has sponsored pure culture through Sangsang Madang and Sangsang Art Hall. In 2010, KT&G received the Cultural Contribution Award from the Korean Business Council for Arts for supporting non-mainstream culture through its complex cultural spaces and its contribution to their popularization.

### Talent Sharing Activities-Sangsang Together, Sangsang Volunteer, Sangsang Univ.

#### Sangsang Together

KT&G's volunteer programs try to maximize the use of employee talents and characteristics. Sangsang Together is a KT&G employee volunteer group formed to help resolve local community problems and practice corporate's social responsibility.

### Sangsang Volunteer

Sangsang Volunteer is a university student volunteer group. It plans and conducts volunteer activities on its own and helps create a happy nation. With volunteer as a medium, the group creates a platform of communication and helps its members make a difference. There are about 7,000 Sangsang volunteer members.

### Sangsang Univ.

Sangsang Univ. offers aspiring artists who have unique ideas and style, a stage to express their creativity. It allows them to bond, compete, and share various arts and culture. The community supports five areas, which are dance, band music, photography, video art and cinematography, through education, mentoring, and various participatory programs. Sangsang Univ is an art and culture community where participants not only get a theoretical learning but also participate, express, meet, and share with one another.

#### KT&G Sangsang Madang's Activities

Performance	Cinema	Visual Art	Design	Academy	Communication
Band incubating, Special performances, Rental performances	Movie projection, Production, Distribution, CineLab	Fine art exhibitions, Exhibitions of non-mainstream arts and culture, Photography exhibitions and support of photographers	Exhibitions and distribution, Support of designers and mass production	Education on arts and culture for adults, Programs to foster arts and culture talents, Creative activities for youths, Lecture business	Citizen participation programs, Events, Space tours, Community FAM Tour membership, Supporters



## Independent Auditors' Report

Based on a report originally issued in Korean



KPMG SAMJONG Accounting Corp.

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### The Board of Directors and Shareholders KT&G Corporation:

We have audited the accompanying consolidated statements of financial position of KT&G Corporation and its subsidiaries (the "Group") as of December 31, 2011 and 2010, and the related consolidated statements of comprehensive income, changes in equity and cash flows for the years then ended. Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Korean International Financial Reporting Standards. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of KT&G Corporation and its subsidiaries as of December 31, 2011 and 2010 and its financial performance and its cash flows for the years then ended, in accordance with Korean International Financial Reporting Standards.

The accompanying consolidated financial statements as of and for the year ended December 31, 2011 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation and, in our opinion, the consolidated financial statements expressed in Korean won have been translated into dollars on the basis set forth in note 4 to the consolidated financial statements.

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

As discussed in note 32 to the consolidated financial statements, the Group and the Korean government are defendants in lawsuits claiming damages of ₩584 million for the effects of smoking. The final outcome of these lawsuits cannot be predicted.

The procedures and practices utilized in the Republic of Korea to audit such consolidated financial statements may differ from those generally accepted and applied in other countries. Accordingly, this report and the accompanying consolidated financial statements are for use by those knowledgeable about Korean auditing standards and their application in practice.

*KPMG Samjong Accounting Corp.*

KPMG Samjong Accounting Corp.  
Seoul, Korea  
February 16, 2012

This report is effective as of February 16, 2012, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying consolidated financial statements and notes thereto. Accordingly, the readers of the audit report should understand that the above audit report has not been updated to reflect the impact of such subsequent events or circumstances, if any.

# KT&G CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Financial Position

As of December 31, 2011 and 2010

In millions of won and thousands of U.S. dollars

	Note	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
<b>Assets</b>				
Property, plant and equipment	6,15,37	₩ 1,584,346	\$ 1,373,750	₩ 1,510,838
Intangible assets	7,15,37	258,618	224,241	63,145
Investment property	8,15	188,351	163,315	121,483
Equity accounted investments	5,9	35,330	30,634	1,597
Available-for-sale financial assets	10,31	247,359	214,479	314,177
Other financial assets	15,31	1,427	1,237	646
Long-term deposits in MSA Escrow Fund	11,31,32	147,290	127,711	132,414
Long-term advance payments	32	142,879	123,889	138,895
Long-term prepaid expenses		5,776	5,009	6,280
Long-term trade and other receivables	12,31	134,115	116,288	114,540
Deferred tax assets	28	15,487	13,428	11,067
<b>Total non-current assets</b>		<b>2,760,978</b>	<b>2,393,981</b>	<b>2,415,082</b>
Inventories	13	1,572,299	1,363,304	1,497,034
Current available-for-sale financial assets	10,31	1,044	905	1,000
Current other financial assets	31	11,089	9,615	15,273
Prepaid tobacco excise and other taxes		201,910	175,071	177,043
Trade and other receivables	12,31	833,310	722,544	626,409
Advance payments	32	64,342	55,790	41,544
Prepaid expenses		20,517	17,790	22,360
Cash and cash equivalents	14,31	807,731	700,365	981,314
		3,512,242	3,045,384	3,361,977
Assets held for sale	5,33	3,196	2,771	-
<b>Total current assets</b>		<b>3,515,438</b>	<b>3,048,155</b>	<b>3,361,977</b>
<b>Total assets</b>	5	<b>₩ 6,276,416</b>	<b>\$ 5,442,136</b>	<b>₩ 5,777,059</b>

See accompanying notes to the consolidated financial statements.

In millions of won and thousands of U.S. dollars

	Note	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
<b>Equity</b>				
Ordinary shares	1,16	₩ 954,959	\$ 828,023	₩ 954,959
Other capital surplus	16	5,333	4,624	5,333
Treasury shares	17	(343,522)	(297,860)	(216,827)
Gain on reissuance of treasury shares	17	485,922	421,332	482,129
Reserve	18	2,663,312	2,309,297	2,179,227
Retained earnings	19,20	1,022,126	886,262	1,151,358
<b>Equity attributable to owners of the parent</b>	31	<b>4,788,130</b>	<b>4,151,678</b>	<b>4,556,179</b>
<b>Non-controlling interests</b>		<b>96,947</b>	<b>84,061</b>	<b>42,130</b>
<b>Total equity</b>		<b>4,885,077</b>	<b>4,235,739</b>	<b>4,598,309</b>
<b>Liabilities</b>				
Long-term borrowings	15,21,31	37,847	32,816	1,540
Long-term trade and other payables	15,22,31	26,031	22,571	22,880
Long-term advance receipts	25	14,072	12,202	10,935
Defined benefit liabilities	24	83,082	72,039	48,324
Provision		3,510	3,042	2,220
Deferred tax liabilities	28	227,589	197,337	167,503
<b>Total non-current liabilities</b>		<b>392,131</b>	<b>340,007</b>	<b>253,402</b>
Short-term borrowings	15,23,31	82,836	71,826	66,507
Current portion of long-term borrowings	15,21,31	3,126	2,710	506
Trade and other payables	22,31	422,734	366,543	301,211
Advance receipts		12,628	10,948	9,335
Income tax payable	28	164,579	142,703	222,932
Tobacco excise and other taxes payable		313,305	271,660	324,857
<b>Total current liabilities</b>		<b>999,208</b>	<b>866,390</b>	<b>925,348</b>
<b>Total liabilities</b>	5	<b>1,391,339</b>	<b>1,206,397</b>	<b>1,178,750</b>
<b>Total equity and liabilities</b>		<b>₩ 6,276,416</b>	<b>\$ 5,442,136</b>	<b>₩ 5,777,059</b>

See accompanying notes to the consolidated financial statements.

# KT&G CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

For the years ended December 31, 2011 and 2010

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

	Note	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
Sales	5,30	₩ 3,722,966	\$ 3,228,098	₩ 3,461,418
Cost of sales	30	(1,607,591)	(1,393,905)	(1,446,708)
<b>Gross profit</b>		2,115,375	1,834,193	2,014,710
Other income	26	119,067	103,240	139,607
Selling expenses	26	(715,241)	(620,169)	(592,523)
General and administrative expenses	26	(308,256)	(267,282)	(328,531)
Employee welfare fund		-	-	(12,492)
Other expense	26	(90,316)	(78,311)	(80,677)
<b>Profit from operations</b>	5	1,120,629	971,671	1,140,094
Net finance income	27	39,118	33,919	265,869
Share of gain of associates	9	1,325	1,149	-
Share of loss of associates	9	(8)	(7)	(288)
<b>Profit before income tax</b>		1,161,064	1,006,732	1,405,675
Income tax expense	28	(344,135)	(298,392)	(374,886)
<b>Profit for the year</b>		₩ 816,929	\$ 708,340	₩ 1,030,789
<b>Other comprehensive income (loss):</b>				
Available-for-sale financial assets, net of tax	10,27,28	₩ (49,889)	\$ (43,257)	₩ (110,759)
Exchange differences				
on translating foreign operations, net of tax	28	(10,026)	(8,694)	(6,637)
Actuarial losses, net of tax	24,28	(19,449)	(16,864)	(7,590)
<b>Other comprehensive loss for the year, net of tax</b>		(79,364)	(68,815)	(124,986)
<b>Total comprehensive income for the year</b>		₩ 737,565	\$ 639,525	₩ 905,803
<b>Profit attributable to:</b>				
- Owners of the parent		₩ 816,058	\$ 707,585	₩ 1,031,824
- Non-controlling interests		871	755	(1,035)
		₩ 816,929	\$ 708,340	₩ 1,030,789
<b>Total comprehensive income attributable to:</b>				
- Owners of the parent		₩ 737,799	\$ 639,728	₩ 907,461
- Non-controlling interests		(234)	(203)	(1,658)
		₩ 737,565	\$ 639,525	₩ 905,803
<b>Earnings per share in won and U.S. dollars:</b>				
Basic and diluted	29	₩ 6,451	\$ 5.59	₩ 8,109

See accompanying notes to the consolidated financial statements.

# KT&G CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Changes in Equity

For the year ended December 31, 2011

In millions of won

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Owners of the parent	Non controlling interests	Total equity
<b>Balance at January 1, 2011</b>	₩ 954,959	5,333	(216,827)	482,129	2,179,227	1,151,358	4,556,179	42,130	4,598,309
<b>Total comprehensive income for the year:</b>									
Profit for the year	-	-	-	-	-	816,058	816,058	871	816,929
<b>Other comprehensive income (loss):</b>									
Available-for-sale financial assets, net of tax	-	-	-	-	(49,889)	-	(49,889)	-	(49,889)
Exchange differences									
on translating foreign operations, net of tax	-	-	-	-	(10,026)	-	(10,026)	-	(10,026)
Actuarial losses, net of tax	-	-	-	-	-	(18,344)	(18,344)	(1,105)	(19,449)
<b>Total other comprehensive loss</b>	-	-	-	-	(59,915)	(18,344)	(78,259)	(1,105)	(79,364)
<b>Total comprehensive income (loss) for the year</b>	-	-	-	-	(59,915)	797,714	737,799	(234)	737,565
<b>Transactions with owners and others, recorded directly in equity:</b>									
Dividends	-	-	-	-	-	(382,946)	(382,946)	-	(382,946)
Transfer to unconditional reserve	-	-	-	-	544,000	(544,000)	-	-	-
Reissuance of treasury shares	-	-	2,976	3,793	-	-	6,769	-	6,769
Reacquisition of treasury shares	-	-	(129,671)	-	-	-	(129,671)	-	(129,671)
Acquisition of non-controlling interests	-	-	-	-	-	-	-	55,051	55,051
<b>Total transactions with owners and others</b>	-	-	(126,695)	3,793	544,000	(926,946)	(505,848)	55,051	(450,797)
<b>Balance at December 31, 2011</b>	₩ 954,959	5,333	(343,522)	485,922	2,663,312	1,022,126	4,788,130	96,947	4,885,077

See accompanying notes to the consolidated financial statements.

# KT&G CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Changes in Equity

For the year ended December 31, 2011

In thousands of U.S. dollars

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Owners of the parent	Non controlling interests	Total equity
<b>Balance at January 1, 2011</b>	\$ 828,023	4,624	(188,006)	418,043	1,889,558	998,317	3,950,559	36,530	3,987,089
<b>Total comprehensive income for the year:</b>									
Profit for the year	-	-	-	-	-	707,585	707,585	755	708,340
<b>Other comprehensive income (loss):</b>									
Available-for-sale financial assets, net of tax	-	-	-	-	(43,257)	-	(43,257)	-	(43,257)
Exchange differences									
on translating foreign operations, net of tax	-	-	-	-	(8,694)	-	(8,694)	-	(8,694)
Actuarial losses, net of tax	-	-	-	-	-	(15,906)	(15,906)	(958)	(16,864)
<b>Total other comprehensive loss</b>	-	-	-	-	(51,951)	(15,906)	(67,857)	(958)	(68,815)
<b>Total comprehensive income (loss) for the year</b>	-	-	-	-	(51,951)	691,679	639,728	(203)	639,525
<b>Transactions with owners and others, recorded directly in equity:</b>									
Dividends	-	-	-	-	-	(332,044)	(332,044)	-	(332,044)
Transfer to unconditional reserve	-	-	-	-	471,690	(471,690)	-	-	-
Reissuance of treasury shares	-	-	2,580	3,289	-	-	5,869	-	5,869
Reacquisition of treasury shares	-	-	(112,434)	-	-	-	(112,434)	-	(112,434)
Acquisition of non-controlling interests	-	-	-	-	-	-	-	47,734	47,734
<b>Total transactions with owners and others</b>	-	-	(109,854)	3,289	471,690	(803,734)	(438,609)	47,734	(390,875)
<b>Balance at December 31, 2011</b>	\$ 828,023	4,624	(297,860)	421,332	2,309,297	886,262	4,151,678	84,061	4,235,739

See accompanying notes to the consolidated financial statements.

For the year ended December 31, 2010

In millions of won

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Owners of the parent	Non controlling interests	Total equity
<b>Balance at January 1, 2010</b>	₩ 954,959	5,321	(226,945)	468,274	2,075,269	704,012	3,980,890	27,112	4,008,002
<b>Total comprehensive income for the year:</b>									
Profit for the year	-	-	-	-	-	1,031,824	1,031,824	(1,035)	1,030,789
<b>Other comprehensive income (loss):</b>									
Available-for-sale financial assets, net of tax	-	-	-	-	(110,759)	-	(110,759)	-	(110,759)
Exchange differences									
on translating foreign operations, net of tax	-	-	-	-	(6,637)	-	(6,637)	-	(6,637)
Actuarial losses, net of tax	-	-	-	-	-	(6,967)	(6,967)	(623)	(7,590)
<b>Total other comprehensive loss</b>	-	-	-	-	(117,396)	(6,967)	(124,363)	(623)	(124,986)
<b>Total comprehensive income (loss) for the year</b>	-	-	-	-	(117,396)	1,024,857	907,461	(1,658)	905,803
<b>Transactions with owners and others, recorded directly in equity:</b>									
Dividends	-	-	-	-	-	(356,157)	(356,157)	-	(356,157)
Transfer from reserve for									
research and human resource development	-	-	-	-	(15,000)	15,000	-	-	-
Transfer from reserve for									
loss on reissuance of treasury shares	-	-	-	-	(26,646)	26,646	-	-	-
Transfer to reserve for									
research and human resource development	-	-	-	-	60,000	(60,000)	-	-	-
Transfer to unconditional reserve	-	-	-	-	203,000	(203,000)	-	-	-
Reissuance of treasury shares	-	-	10,118	13,855	-	-	23,973	-	23,973
Issuance of subsidiaries' share capital	-	12	-	-	-	-	12	16,676	16,688
<b>Total transactions with owners and others</b>	-	12	10,118	13,855	221,354	(577,511)	(332,172)	16,676	(315,496)
<b>Balance at December 31, 2010</b>	₩ 954,959	5,333	(216,827)	482,129	2,179,227	1,151,358	4,556,179	42,130	4,598,309

See accompanying notes to the consolidated financial statements.

# KT&G CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

For the years ended December 31, 2011 and 2010

In millions of won and thousands of U.S. dollars

Note	2011 Korean won	2011 U.S. dollars (note 4)	2010 Korean won
<b>Cash flows from operating activities</b>			
Cash generated from operations	34 ₩ 1,111,648	\$ 963,884	₩ 1,098,707
Income tax paid	(354,794)	(307,634)	(253,596)
<b>Net cash from operating activities</b>	<b>756,854</b>	<b>656,250</b>	<b>845,111</b>
<b>Cash flows from investing activities</b>			
Interest received	33,210	28,795	20,547
Investment income received			
from long-term deposits in MSA Escrow Fund	10,582	9,176	1,244
Dividends received	7,116	6,170	2,056
Proceeds from sale of property, plant and equipment	32,716	28,367	35,726
Proceeds from sale of intangible assets	25,473	22,087	1,016
Proceeds from sale of assets held for sale	977	847	100,830
Proceeds from sale of available-for-sale financial assets	2,570	2,229	265,678
Proceeds from sale of subsidiaries	113	98	-
Collection of loans	21,972	19,052	47,796
Withdrawal of guarantee deposits	36,916	32,009	39,793
Decrease in financial instruments	7,950	6,893	-
Acquisition of property, plant and equipment	(288,529)	(250,177)	(211,636)
Acquisition of intangible assets	(18,202)	(15,782)	(13,606)
Acquisition of investment property	(2,136)	(1,852)	-
Acquisition of equity accounted investment	(16,595)	(14,389)	-
Acquisition of available-for-sale financial assets	(22,316)	(19,349)	(39,923)
Increase in loans	(7,412)	(6,427)	(16,023)
Acquisition of subsidiaries	(194,539)	(168,680)	-
Payments for guarantee deposits	(42,452)	(36,809)	(49,004)
Payments for long-term deposits in MSA Escrow Fund	(15,150)	(13,136)	(13,625)
Increase in financial instruments	(1,308)	(1,134)	(14,707)
Others, net	428	369	(1,810)
<b>Net cash provided by (used in) investing activities</b>	<b>(428,616)</b>	<b>(371,643)</b>	<b>154,352</b>
<b>Cash flows from financing activities</b>			
Interest paid	(3,563)	(3,090)	(2,717)
Dividends paid	(382,946)	(332,044)	(356,157)
Proceeds from borrowings	56,844	49,288	45,832
Increase in deposits received	10,135	8,788	5,633
Proceeds from issuance of subsidiaries' share capital	10	9	16,688
Reissuance of treasury shares	7,980	6,919	28,396
Repayment of borrowings	(52,777)	(45,761)	(63,370)
Decrease in deposits received	(6,551)	(5,680)	(6,969)
Reacquisition of treasury shares	(129,671)	(112,435)	-
<b>Net cash used in financing activities</b>	<b>(500,539)</b>	<b>(434,006)</b>	<b>(332,664)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(172,301)</b>	<b>(149,399)</b>	<b>666,799</b>
Cash and cash equivalents at beginning of year	981,314	850,875	316,672
Effect of exchange rate fluctuation on cash held	(1,282)	(1,111)	(2,157)
<b>Cash and cash equivalents at end of year</b>	<b>₩ 807,731</b>	<b>\$ 700,365</b>	<b>₩ 981,314</b>

See accompanying notes to the consolidated financial statements.

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

### 1. ORGANIZATION AND DESCRIPTION OF BUSINESS

KT&G Corporation (the "Parent 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 Parent Company changed its name to Korea Tobacco and Ginseng Corporation pursuant to the Korea Tobacco and Ginseng Corporation Act. Also, pursuant to the Act on Management Reform and Privatization of Public Enterprises, proclaimed on August 28, 1997 and enforced on October 1, 1997, the Parent Company was excluded from the application of the Act for the Management of Government Invested Enterprises. Accordingly, the Parent Company became an entity existing and operating under the Commercial Code of Korea. The Korean government sold 28,650,000 shares of the Parent Company to the public during 1999 and the Parent Company listed its shares on the Korea Exchange (formerly, the Korea Stock Exchange) on October 8, 1999. On December 27, 2002, the Parent Company changed its name again to KT&G Corporation from Korea Tobacco and Ginseng Corporation.

As of December 31, 2011, the Parent Company has four manufacturing plants, including the Shintanjin plant, and 14 local headquarters and 139 branches for the sale of tobacco throughout the country. Also, the Parent 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 Parent Company is located in Pyeongchon-dong, 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 Parent Company into two companies by setting up a subsidiary for its red ginseng business segment effective January 1, 1999. The separation was accomplished by the Parent Company's contribution of the assets and liabilities in the red ginseng business segment into a wholly-owned subsidiary, Korea Ginseng Corporation.

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

The ownership of the Parent Company's issued ordinary shares as of December 31, 2011 is held as follows:

In millions of won, except number of shares and percentage of ownership

Shareholder	Number of shares	Percentage of ownership	Amount
Industrial Bank of Korea	9,510,485	6.93%	47,552
Employee Share Ownership Association	3,285,456	2.39%	16,427
Treasury shares	11,543,697	8.41%	57,719
Others	112,952,859	82.27%	564,764
Retirement of treasury shares	-	-	268,497
	137,292,497	100.00%	954,959

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

### 2. BASIS OF PREPARATION

#### (a) Statement of Compliance

The consolidated financial statements have been prepared in accordance with Korean International Financial Reporting Standards ("K-IFRS"), as prescribed in *the Act on External Audit of Corporations in the Republic of Korea*. K-IFRS is effective from the fiscal year beginning on or after January 1, 2011 and the Group early-adopted K-IFRS from 2009.

#### (b) Basis of Measurement

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

- available-for-sale financial assets measured at fair value
- inventories valued at net realizable value.

#### (c) Use of Estimates and Judgments

The preparation of the consolidated financial statements in conformity with K-IFRS requires management to make judgments, 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.

Information about critical judgements in applying accounting policies that have the most significant effect on the amounts recognized in the consolidated financial statements is included in the following notes:

- classification of investment property - note 8
- deferred revenue - note 25.

Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year is included in the following notes:

- measurement of defined benefit obligations - note 24
- provisions and contingencies - note 32.

### 3. SIGNIFICANT ACCOUNTING POLICIES

#### (a) Basis of Consolidation

##### *Subsidiaries*

A subsidiary is an entity controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of the other entity so as to obtain benefit from its activities. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

If a member of the Group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements.

Non-controlling interests in a subsidiary are accounted for separately from the parent's ownership interests in a subsidiary. Each component of net profit or loss and other comprehensive income is attributed to the owners of the parent and non-controlling interest holders, even when the allocation reduces the non-controlling interest balance below zero.

##### *Associates*

An associate is an entity in which the Group has significant influence, but not control, over the entity's financial and operating policies. The investment in an associate is initially recognized at cost and the carrying amount is increased or decreased to recognize the Group's share of the profit or loss and changes in equity of the associate after the date of acquisition. If an associate uses accounting policies other than those of the Group for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in applying the equity method.

##### *Business Combination*

A business combination is accounted for by applying the acquisition method, unless it is a combination involving entities or businesses under common control. The consideration transferred in a business combination is measured at fair value, which is calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer. Costs related to the acquisition, other than those associated with the issuance of debt or equity securities, that the Group incurs in connection with a business combination are expensed as incurred.

The Group measures goodwill at the acquisition date as the fair value of the consideration transferred, including the recognized amount of any non-controlling interest in the acquiree and the fair value of the pre-existing equity interest in the acquiree for a business combination achieved in stages, less the net recognized amount (generally fair value) of the identifiable assets acquired and the liabilities assumed. When the excess is negative, bargain purchase gain is recognized immediately in profit or loss.

The Group measures components of non-controlling interests in the acquiree at the present ownership instruments' proportionate share in the recognized amounts of the acquiree's identifiable net assets. All other components of non-controlling interests are measured at their acquisition-date fair values.

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

### Transactions Eliminated on Consolidation

Intra-group balances and transactions, and any unrealized income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

### (b) Foreign Currencies

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

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.

Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements are recognized in profit or loss in the period in which they arise. When gains or losses on non-monetary items are recognized in other comprehensive income, exchange components of those gains or losses are recognized in other comprehensive income. Conversely, when gains or losses on non-monetary items are recognized in profit or loss, exchange components of those gains or losses are recognized in profit or loss.

If the functional currency of foreign operations differs from the Group's presentation currency, assets and liabilities for each statement of financial position presented (including comparatives) are translated using the exchange rate at the date of that statement of financial position and income and expenses for each statement of comprehensive income presented (including comparatives) are translated using the exchange rates at the dates of the transactions. All resulting exchange differences are recognized in other comprehensive income.

### (c) Property, Plant and Equipment

Property, plant and equipment are initially measured at cost and after initial recognition, are carried at cost less accumulated depreciation and accumulated impairment losses. The cost of property, plant and equipment includes expenditures arising directly from the construction or acquisition of the asset, any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management and the initial estimate of the costs of dismantling and removing the item and restoring the site on which they are located. In addition, in the preparation of the opening K-IFRS consolidated statement of financial position on the date of transition to K-IFRS, the Group measured some land at deemed cost which is fair value at the date of transition in accordance with K-IFRS No.1101 *First-time Adoption of Korean International Financial Reporting Standards* ("K-IFRS No. 1101").

Subsequent costs are recognized in the carrying amount of property, plant and equipment at cost or, if appropriate, as separate items if it is probable that future economic benefits associated with the item will flow to the Group 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.

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 Group's assets are as follows:

	Useful lives (years)
Buildings and structures	4 ~ 60
Machinery and vehicles	2 ~ 20
Tools, furniture and fixtures	4 ~ 5

A component that is significant compared to the total cost of property, plant and equipment is depreciated over its separate useful life.

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.

### (d) Goodwill

Goodwill that arises upon the acquisition of subsidiaries is included in intangible assets. The Group measures goodwill at the acquisition date as the fair value of the consideration transferred, less the net recognized amount of the identifiable assets acquired and liabilities assumed. Goodwill is regarded as having an indefinite useful life and is not amortized but tested for impairment annually and when there is any indication that it may be impaired. Goodwill is carried at cost less accumulated impairment losses.

### (e) Intangible Assets Other than Goodwill

Intangible assets are measured initially at cost and after initial recognition, are carried at cost less accumulated amortization and accumulated impairment losses. Intangible assets consist of industrial property rights, facility usage rights and other intangible assets. 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 facility usage rights and some of the industrial property 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 were as follows:

	Useful lives (years)
Industrial property rights	10 ~ 20 or indefinite
Facility usage rights	indefinite
Other intangible assets	4 ~ 15 or 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.

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

### (f) Investment Property

Property held for the purpose of earning rentals or benefiting from capital appreciation is classified as investment property. Investment property is measured initially at its cost including transaction costs and after initial recognition, is carried at cost less accumulated depreciation and 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 Group 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 properties, except for land, are depreciated on a straight-line basis over 10 ~ 60 years, the 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) 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 merchandise, 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.

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 ₩421,645 million and ₩403,082 million as of December 31, 2011 and 2010, respectively.

### (h) Non-derivative Financial Assets

The Group classifies a non-derivative financial asset into the following four categories: financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables or available-for-sale financial assets, relating to recognition and measurement of financial assets. The Group recognizes financial assets in the consolidated statements of financial position when the Group becomes a party to the contractual provisions of the financial asset. The Group derecognizes financial assets from the consolidated statements of financial position when the contractual rights to the cash flows from the financial asset expire or the Group transfers the contractual rights to receive the cash flows on the financial asset in a transaction in which all the risks and rewards of ownership of the financial asset are substantially transferred. If the Group retains substantially all the risks and rewards of ownership of the transferred financial assets, the Group continues to recognize the transferred financial asset and recognizes financial liabilities for the consideration received.

Non-derivative financial assets comprise investments in equity and debt securities, long-term deposits in MSA Escrow Fund, trade and other receivables and cash and cash equivalents. When non-derivative financial assets are recognized initially, the Group measures it at its fair value plus, in the case of financial assets not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset.

#### *Financial Assets at Fair Value through Profit or Loss*

Financial assets are classified 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.

#### *Held-to-maturity Investments*

Non-derivative financial assets with fixed or determinable payments and fixed maturity that the Group has the positive intention and ability to hold to maturity are classified as held-to-maturity investments. After initial recognition, held-to-maturity investments are measured at amortized cost using the effective interest method.

#### *Loans and Receivables*

Loans and receivables are trade receivables, loans and other receivables with fixed or determinable payments that are not quoted in an active market. After initial recognition, loans and receivables are measured at amortized cost using the effective interest method except for short-term receivables of which the effect of discounting is immaterial.

#### *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 and changes therein are recognized directly in other comprehensive income, except for impairment losses and foreign exchange gains and losses on monetary available-for-sale financial assets. Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are measured at cost. When the financial asset is derecognized or impairment losses is recognized, the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit or loss. Dividends on an available-for-sale equity instrument are recognized in profit or loss when the Group's right to receive payment is established.

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

### (i) Cash and Cash Equivalents

Cash and cash equivalents comprise cash on hand, demand deposits and short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date. Bank overdrafts are included as a component of cash and cash equivalents for the purpose of the consolidated statements of cash flows.

### (j) Non-derivative Financial Liabilities

The Group classifies non-derivative financial liabilities into financial liabilities at fair value through profit or loss or other financial liabilities in accordance with the substance of the contractual arrangement and the definitions of financial liabilities. The Group recognizes financial liabilities in the consolidated statements of financial position when the Group becomes a party to the contractual provisions of the financial liability and removes financial liabilities from the consolidated statements of financial position when the financial liability is extinguished.

Non-derivative financial liabilities comprise borrowings and trade and other payables. When non-derivative financial liabilities are recognized initially, the Group measures it at its fair value minus, in the case of financial liabilities not at fair value through profit or loss, transaction costs that are directly attributable to the issuance of the financial liability.

#### *Financial Liabilities at Fair Value through Profit or Loss*

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

#### *Other Financial Liabilities*

Other financial liabilities are those non-derivative financial liabilities that are not classified as financial liabilities at fair value through profit or loss. After initial recognition, other financial liabilities are measured at amortized cost using the effective interest method except for short-term liabilities of which the effect of discounting is immaterial.

### (k) Non-current Assets Held for Sale

The Group classifies a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use, and measures it at the lower of its carrying amount and fair value less costs to sell.

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

The Group recognizes an impairment loss for write-downs of the asset (or disposal group) to fair value less costs to sell and a gain for increases in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognized previously in accordance with K-IFRS No.1036 Impairment of Assets.

### (l) Revenue Recognition

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

Revenue from sale 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 Group has transferred to the buyer the significant risks and rewards of ownership of the goods, the Group 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 Group 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 years ended December 31, 2011 and 2010 were ₩3,462,687 million and ₩3,363,885 million, respectively.

Revenue from the construction of real estate includes the initial amount agreed in the contract plus any variations in contract work, claims and incentive payments, to the extent that it is probable that they will result in revenue and can be measured reliably. As soon as the outcome of a construction contract can be estimated reliably, contract revenue is recognized in profit or loss in proportion to the stage of completion of the contract. The stage of completion is assessed by reference to surveys of work performed.

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 Group, 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.

Revenue from the use by others of the Group's assets yielding interest, royalties and dividends is recognized when it is probable that the economic benefits associated with the transaction will flow to the Group and the amount of the revenue can be measured reliably.

In addition, interest is recognized using the effective interest method, royalties are recognized on an accrual basis in accordance with the substance of the relevant agreement and dividends are recognized when the shareholders' right to receive the dividend is established.

### (m) Impairment of Non-financial Assets

The Group assesses at the end of each reporting period whether there is any indication that an asset may be impaired except for inventories, deferred tax assets, assets arising from employee benefits and non-current assets (or disposal groups) classified as held for sale. If any such indication exists, the Group estimates the recoverable amount of the asset. Intangible assets with indefinite useful lives or intangible assets not yet available for use are tested for impairment annually, irrespective of whether there is any indication that it may be impaired. If there is any indication that an asset may be impaired, the recoverable amount is estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, the Group determines the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

The recoverable amount is measured as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value-in-use. If the recoverable amount of an asset or cash-generating unit is less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. That reduction is recognized in profit or loss.

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### (n) Impairment of Financial Assets

The Group assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired, except for financial assets at fair value through profit or loss. A financial asset or group of financial assets is considered to be impaired if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset and that loss event has an impact on the estimated future cash flows of the financial asset. For specific financial assets such as trade receivables, if the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, it collectively assesses them for impairment. The objective evidence that the group of loans and receivables are impaired includes an increased number of delayed payments and an adverse change in national or local economic conditions that correlate with defaults on the assets in the group.

The amount of the impairment loss on financial assets carried at amortized cost is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced either directly or through the use of an allowance account. The amount of the loss is recognized in profit or loss. 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. The reversal does not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal is recognized in profit or loss.

The amount of the reversal is recognized in profit or loss. The amount of the impairment loss on financial assets carried at cost 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.

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 equity 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.

### (o) Income Tax

Income tax expense comprises current tax expense and deferred tax expense. 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.

Current tax expense is the amount of income tax payable (recoverable) in respect of the taxable profit (tax loss) for a period. Current tax liabilities (assets) for the current and prior periods are measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates that have been enacted or substantively enacted by the end of the reporting period.

Deferred tax assets and liabilities are recognized for temporary differences which are differences between the carrying amount of an asset or liability in the consolidated statements of financial position and its tax base, the carryforward of unused tax losses and unused tax credits. 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 that have been enacted or substantively enacted by the end of the reporting period.

The Group recognizes a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries and associates, except to the extent that the Group is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The Group recognizes a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries and associates, 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. The Group reduces the carrying amount of a deferred tax asset 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 these deferred tax assets to be utilized. Such reduction is reversed to the extent that it becomes probable that sufficient taxable profit will be available.

### (p) Dividends

The dividends declared to holders of equity instruments after the reporting period are not recognized as a liability at the end of the reporting period.

### (q) Equity Capital

Ordinary shares are classified as equity. Incremental costs directly attributable to the equity transaction are recognized as a deduction from equity, net of any tax effects.

When the Group reacquires its share capital, the amount of the consideration paid is recognized as a deduction from equity and classified as treasury shares. The gain or loss on the purchase, sale, reissuance or cancellation of treasury shares is not recognized in profit or loss but recognized directly in equity.

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### (r) Provisions, Contingent Assets and Contingent Liabilities

Provisions are recognized when the Group 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 amount recognized as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. 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, the amount of a provision is the present value of the expenditures expected to be required to settle the obligation.

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

Provisions are reviewed at the end of each reporting period and adjusted to reflect the current best estimate. 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.

In addition, with regard to returns, the Group recognizes revenue, net of estimated returns and provides for the estimated liability at the time revenue is recognized. The related estimated cost of returns is added to the cost of sales or selling, general and administrative expenses. At the point of return, differences arising from estimates are recognized as cost of sales or selling, general and administrative expenses.

### (s) Employee Benefits

#### *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 Group during an accounting period, the Group recognizes the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service.

The Group recognizes the expected cost of profit-sharing and bonus payments if the Group has a present legal or constructive obligation to make such payments as a result of past events; and a reliable estimate of the obligation can be made.

#### *Retirement Benefits: Defined Contribution Plans*

With regard to the defined contribution plan, when an employee has rendered service to the Group during a period, the Group 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 Group 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.

#### *Retirement Benefits: Defined Benefit Plans*

The Group classifies retirement benefits plans other than defined contribution plans as defined benefit plans. The defined benefit liabilities are calculated at the present value of the defined benefit obligations less the fair value of the plan assets at the end of the reporting period.

In determining the present value of its defined benefit obligations and the related current service cost, the Group uses the projected unit credit method.

With regard to actuarial gains and losses which arise from application of actuarial assumptions, the Group recognizes all actuarial gains and losses in other comprehensive income. Actuarial gains and losses recognized in other comprehensive income are recognized immediately in retained earnings and are not reclassified to profit or loss in a subsequent period.

#### *Termination Benefits*

The Group recognizes termination benefits as a liability and an expense when, and only when, the Group is demonstrably committed to terminating the employment of an employee or group of employees before the normal retirement date or providing termination benefits as a result of an offer made in order to encourage voluntary redundancy.

### (t) Deferred Revenue

With regard to ginseng sales, the Group uses the customer loyalty program to provide customers with incentives to buy its goods. If a customer buys goods, the Group awards the customer points which can be redeemed in the future for free or discounted goods. The fair value of the consideration received or receivable in respect of the initial sale is allocated between the points and the other components of the sale. The consideration allocated to the points is estimated by considering the fair value of ginseng provided to customers for the redemption of points and expected rate and timing of redemption. The Group recognizes the consideration allocated to the points as revenue when the points are redeemed and the Group fulfils its obligations to supply awards.

### (u) Earnings per Share

The Group presents basic and diluted earnings per share ("EPS") data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss for the year attributable to owners of the Parent Company by the weighted-average number of shares outstanding during the period.

Diluted EPS is determined by adjusting the profit or loss for the year attributable to owners of the Parent Company and the weighted-average number of shares outstanding for the effects of all dilutive potential shares, which comprise employee share options.

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### (v) Operating Segments

A segment is a distinguishable component of the Group that is engaged in providing products or services, which is determined based on the Group's internal report that is regularly reviewed by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Group has four operating segments - manufacturing and selling tobaccos (the "Tobacco" segment), manufacturing and selling ginseng products (the "Ginseng" segment), sales or rent of real estate (the "Real Estate" segment) and other operations. The prices agreed between the Group companies for intra-group transactions are based on normal commercial practices which would apply between independent businesses.

### (w) New Standards and Interpretations Not Yet Adopted

The following new standards, interpretations and amendments to existing standards have been published and are mandatory for the Group for annual periods beginning after January 1, 2011, and the Group has not early adopted them. Management believes the impacts of the amendments on the Group's consolidated financial statements are insignificant.

#### (i) Amendments to K-IFRS No. 1107 *Financial Instruments: Disclosures*

The amendments require disclosing the nature of the transferred assets, their carrying amount, and the description of risks and rewards for each class of transferred financial assets that are not derecognized in their entirety. If the Group derecognizes transferred financial assets but still has their specific risks and rewards, the amendments require additional disclosures on their effect of risks. The amendments will be applied prospectively for the Group's annual periods beginning on or after July 1, 2011.

#### (ii) Amendments to K-IFRS No. 1012 *Income Tax*

Deferred tax assets or deferred tax liabilities on investment properties measured at fair value, unless any contrary evidence exists, will be measured by reflecting the tax effect from selling the investment properties. The amendments will be prospectively applied for the Group's annual periods beginning on or after January 1, 2012.

#### (iii) Amendments to K-IFRS No. 1019 *Employee Benefits*

The standard requires recognition of actuarial gains and losses immediately in other comprehensive income and to calculate expected return on plan assets based on the rate used to discount the defined benefit obligation. The standard will be applied retrospectively for the Group's annual periods beginning on or after January 1, 2013.

#### (iv) K-IFRS No. 1113 *Fair Value Measurement*

The standard defines fair value and a single framework for fair value, and requires disclosures about fair value measurements. The standard will be applied prospectively for the Group's annual periods beginning on or after January 1, 2013.

### 4. BASIS OF TRANSLATING FINANCIAL STATEMENTS

The consolidated financial statements are expressed in Korean won and have been translated into U.S. dollars at the rate of ₩1,153.30 to \$1, the basic exchange rate on December 31, 2011, 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 United States dollars at this or any other rate.

### 5. OPERATING SEGMENTS

(a) Details of the Group's operating segments are summarized as follows:

Operating segments	Principal operation
Tobacco	Manufacturing and selling tobaccos
Ginseng	Manufacturing and selling red ginseng
Real estate	Selling and renting real estate
Others	Manufacturing and selling pharmaceuticals, cosmetics and others

(b) Segment information on revenue and profit from operations for the year ended December 31, 2011 was as follows:

	In millions of won						
	Tobacco	Ginseng	Real estate	Others	Segment total	Elimination	Consolidated
Total segment sales	₩ 2,624,430	1,025,181	41,814	250,579	3,942,004	(219,038)	3,722,966
Less: Inter-segment sales	78,893	92,321	4,892	42,932	219,038	(219,038)	-
External sales	₩ 2,545,537	932,860	36,922	207,647	3,722,966	-	3,722,966
Profit from operations	₩ 919,307	189,818	7,869	24,333	1,141,327	(20,698)	1,120,629

(c) Segment information on revenue and profit from operations for the year ended December 31, 2010 was as follows:

	In millions of won						
	Tobacco	Ginseng	Real estate	Others	Segment total	Elimination	Consolidated
Total segment sales	₩ 2,397,649	897,446	100,972	151,488	3,547,555	(86,137)	3,461,418
Less: Inter-segment sales	19,645	50,384	3,912	12,196	86,137	(86,137)	-
External sales	₩ 2,378,004	847,062	97,060	139,292	3,461,418	-	3,461,418
Profit from operations	₩ 924,035	226,569	(16,046)	13,285	1,147,843	(7,749)	1,140,094

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## Notes to the Consolidated Financial Statements

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### 5. OPERATING SEGMENTS, CONTINUED

(d) Segment information on assets and liabilities as of December 31, 2011 was as follows:

In millions of won								
	Tobacco	Ginseng	Real estate	Others	Segment total	Elimination	Consolidated	
<b>Assets:</b>								
Segment assets	₩ 3,332,975	1,128,405	154,456	382,278	4,998,114	(121,801)	4,876,313	
Equity accounted investments	-	-	33,681	1,649	35,330	-	35,330	
Assets held for sale	3,196	-	-	-	3,196	-	3,196	
	₩ 3,336,171	1,128,405	188,137	383,927	5,036,640	(121,801)	4,914,839	
Unallocated assets							1,361,577	
<b>Total assets</b>	₩							6,276,416
<b>Liabilities:</b>								
Segment liabilities	₩ 766,856	136,388	-	71,461	974,705	(124,565)	850,140	
Unallocated liabilities							541,199	
<b>Total liabilities</b>	₩							1,391,339

(e) Segment information on assets and liabilities as of December 31, 2010 was as follows:

In millions of won								
	Tobacco	Ginseng	Real estate	Others	Segment total	Elimination	Consolidated	
<b>Assets:</b>								
Segment assets	₩ 3,120,200	893,430	131,313	110,090	4,255,033	(72,563)	4,182,470	
Equity accounted investments	-	-	-	1,597	1,597	-	1,597	
	₩ 3,120,200	893,430	131,313	111,687	4,256,630	(72,563)	4,184,067	
Unallocated assets							1,592,992	
<b>Total assets</b>	₩							5,777,059
<b>Liabilities:</b>								
Segment liabilities	₩ 652,318	73,426	-	33,807	759,551	(61,545)	698,006	
Unallocated liabilities							480,744	
<b>Total liabilities</b>	₩							1,178,750

(f) Segment information on revenue and profit from operations based on the geographical location of customers for the years ended December 31, 2011 and 2010 were as follows:

In millions of won							
		2011			2010		
		Korea	Foreign country	Total	Korea	Foreign country	Total
External sales	₩	2,796,080	926,886	3,722,966	2,718,262	743,156	3,461,418
Profit from operations		914,858	205,771	1,120,629	950,751	189,343	1,140,094

(i) Revenues from major customers of which revenues amount to 10 percent or more of the Group's total revenues for the years ended December 31, 2011 and 2010 were as follows:

In millions of won				
Segment	Major customers		2011	2010
Tobacco	Alokozay International Limited	₩	522,531	498,302

### 6. PROPERTY, PLANT AND EQUIPMENT

(a) Changes in property, plant and equipment for the year ended December 31, 2010 were as follows:

In millions of won					
	Land, buildings and structures	Machinery and vehicles	Tools, furniture, fixtures and other	Construction-in-progress	Total
<b>Balance at January 1, 2010:</b>					
Cost	₩ 1,262,597	1,003,435	239,277	89,389	2,594,698
Accumulated depreciation and impairment	(297,247)	(620,266)	(166,347)	-	(1,083,860)
Carrying amount	₩ 965,350	383,169	72,930	89,389	1,510,838
<b>Changes:</b>					
Acquisition	₩ 47,156	13,409	31,439	196,525	288,529
Business combination	9,229	13,367	4,404	4,673	31,673
Disposal	(12,818)	(2,076)	(856)	(102)	(15,852)
Depreciation	(35,432)	(76,494)	(35,946)	-	(147,872)
Reallocation of construction-in-progress	128,964	41,063	5,418	(175,445)	-
Reclassification from inventories	4,244	-	-	-	4,244
Reclassification from investment property	559	-	-	-	559
Reclassification to investment property	(70,304)	-	-	-	(70,304)
Reclassification to assets held for sale	(8,955)	-	-	-	(8,955)
Net exchange difference	(5,368)	(3,851)	-	705	(8,514)
	₩ 57,275	(14,582)	4,459	26,356	73,508
<b>Balance at December 31, 2010:</b>					
Cost	₩ 1,350,897	1,070,198	284,264	115,745	2,821,104
Accumulated depreciation and impairment	(328,272)	(701,611)	(206,875)	-	(1,236,758)
Carrying amount	₩ 1,022,625	368,587	77,389	115,745	1,584,346

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(b) Changes in property, plant and equipment for the year ended December 31, 2010 were as follows:

	In millions of won				
	Land, buildings and structures	Machinery and vehicles	Tools, furniture, fixtures and other	Construction-in-progress	Total
<b>Balance at January 1, 2010:</b>					
Cost	₩ 1,196,109	981,089	271,729	69,340	2,518,267
Accumulated depreciation and impairment	(266,932)	(585,791)	(193,989)	-	(1,046,712)
Carrying amount	₩ 929,177	395,298	77,740	69,340	1,471,555
<b>Changes:</b>					
Acquisition	₩ 5,859	41,263	33,774	130,740	211,636
Disposal	(4,436)	(7,666)	(1,586)	(123)	(13,811)
Depreciation	(32,173)	(73,281)	(38,364)	-	(143,818)
Reallocation of construction-in-progress	68,969	29,527	1,414	(99,910)	-
Reclassification from investment property	247	-	-	-	247
Reclassification to inventories	-	-	-	(9,449)	(9,449)
Reclassification to expenses	-	-	-	(957)	(957)
Net exchange difference	(2,293)	(1,972)	(48)	(252)	(4,565)
	₩ 36,173	(12,129)	(4,810)	20,049	39,283
<b>Balance at December 31, 2010:</b>					
Cost	₩ 1,262,597	1,003,435	239,277	89,389	2,594,698
Accumulated depreciation and impairment	(297,247)	(620,266)	(166,347)	-	(1,083,860)
Carrying amount	₩ 965,350	383,169	72,930	89,389	1,510,838

7. INTANGIBLE ASSETS

(a) Changes in intangible assets for the year ended December 31, 2011 were as follows:

	In millions of won					
	Goodwill	Industrial property rights	Facility usage rights	Other intangible assets	Intangible assets under development	Total
<b>Balance at January 1, 2011:</b>						
Cost	₩ -	9,944	24,189	15,757	33,360	83,250
Accumulated amortization and impairment	-	(7,895)	-	(11,563)	(647)	(20,105)
Carrying amount	₩ -	2,049	24,189	4,194	32,713	63,145
<b>Changes:</b>						
Separate acquisition	₩ -	447	4,537	11,623	-	16,607
Business combination	87,902	20,952	33	94,857	12,728	216,472
Internally generated	-	-	-	-	1,595	1,595
Disposal	-	(199)	(4,371)	(80)	(14,454)	(19,104)
Amortization	-	(78)	-	(4,416)	-	(4,494)
Impairment	-	-	-	-	(15,914)	(15,914)
Reallocation of intangible assets under development	-	276	-	-	(276)	-
Net exchange difference	-	7	(1)	463	(158)	311
	₩ 87,902	21,405	198	102,447	(16,479)	195,473
<b>Balance at December 31, 2011:</b>						
Cost	₩ 87,902	33,060	24,387	122,670	32,795	300,814
Accumulated amortization and impairment	-	(9,606)	-	(16,029)	(16,561)	(42,196)
Carrying amount	₩ 87,902	23,454	24,387	106,641	16,234	258,618

The Group recognized ₩15,914 million of impairment loss on the intangible asset under development for new medicine. The fair value of the intangible asset is measured using the multi-period-excess-earnings method and relief-from-royalty method, as determined by an independent external valuation.

As discussed in note 30 to the consolidated financial statements, the Parent Company contributed ₩14,454 million of intangible assets under development to Mazence, Inc. as in-kind capital contribution, resulting in ₩6,045 million of gain on sale of intangible assets for the year ended December 31, 2011.

Other intangible assets include customer relationships and brand value acquired as part of a business combination, as discussed in note 37 to the consolidated financial statements. The fair values of customer relationships and brand value are measured using the multi-period-excess-earnings method and relief-from-royalty method, respectively, as determined by an independent external valuation.

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(b) Changes in intangible assets for the year ended December 31, 2010 were as follows:

In millions of won					
	Industrial property rights	Facility usage rights	Other intangible assets	Intangible assets under development	Total
<b>Balance at January 1, 2010:</b>					
Cost	₩ 9,299	20,750	9,733	31,135	70,917
Accumulated amortization and impairment	(7,818)	-	(6,752)	(647)	(15,217)
Carrying amount	₩ 1,481	20,750	2,981	30,488	55,700
<b>Changes:</b>					
Separate acquisition	₩ 485	4,303	5,028	-	9,816
Internally generated	-	-	-	3,790	3,790
Disposal	(106)	(864)	-	(181)	(1,151)
Amortization	(88)	-	(1,236)	-	(1,324)
Impairment	(83)	-	(3,598)	-	(3,681)
Reallocation of intangible assets under development	360	-	1,024	(1,384)	-
Net exchange difference	-	-	(5)	-	(5)
	₩ 568	3,439	1,213	2,225	7,445
<b>Balance at December 31, 2010:</b>					
Cost	₩ 9,944	24,189	15,757	33,360	83,250
Accumulated amortization and impairment	(7,895)	-	(11,563)	(647)	(20,105)
Carrying amount	₩ 2,049	24,189	4,194	32,713	63,145

The Group recognized ₩3,415 million of impairment loss on the intangible assets relating to the acquisition of the sales network in the United States and ₩266 million of impairment loss on the intangible assets relating to the development of synthesis technology for the year ended December 31, 2010.

(c) Research and development expenditures not capitalized for the years ended December 31, 2011 and 2010 were as follows:

In millions of won			
		2011	2010
Cost of sales	₩	1,459	812
Selling expenses		11,827	11,652
General and administrative expenses		17,532	9,898
	₩	30,818	22,362

(d) For the purpose of impairment testing, goodwill is allocated to the Group's operating divisions which represent the lowest level within the Group at which the goodwill is monitored for internal management purposes (the cash-generating unit, "CGU"). The aggregate carrying amounts of goodwill allocated to each unit as of December 31, 2011 and 2010 are as follows:

In millions of won			
Operating segment		2011	2010
Tobacco	Renzoluc Pte., Ltd.	₩ 53,341	-
Others	Manufacturing and selling pharmaceuticals	2,430	-
	Manufacturing and selling cosmetics	32,131	-
		₩ 87,902	-

The recoverable amount of the CGU was estimated based on its value-in-use. The estimate of value-in-use was determined using pre-tax cash flow projections of the Group's five-year financial budgets approved by management. Cash flow projections beyond five years were extrapolated using a steady growth rate, which does not exceed the long-term average growth rate for the industry in which the CGU operates. The calculation of the value-in-use was based on the following key assumptions:

- The anticipated annual revenue growth rate and the related cost ratio included in the cash flow projections for the first five years have been based on past average growth levels.
- Cash flows for beyond five years were projected using a steady growth rate of 0.00%~3.90%.
- The discount rate was estimated based on each CGU's weighted average cost of capital

The values assigned to the key assumptions represent management's assessment of future trends in the related CGU, and are based on both external sources and internal sources (historical data). Based on the assessment, the estimated recoverable amount of goodwill exceeds its carrying amount.

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### 8. INVESTMENT PROPERTY

(a) Changes in investment property for the year ended December 31, 2011 were as follows:

		In millions of won		
		Land	Buildings	Total
<b>Balance at January 1, 2011:</b>				
Cost	₩	36,550	121,890	158,440
Accumulated depreciation and impairment		-	(36,957)	(36,957)
Carrying amount	₩	36,550	84,933	121,483
<b>Changes:</b>				
Subsequent expenditure	₩	-	2,136	2,136
Depreciation		-	(5,013)	(5,013)
Reclassification from property, plant and equipment		9,032	61,272	70,304
Reclassification to property, plant and equipment		(268)	(291)	(559)
	₩	8,764	58,104	66,868
<b>Balance at December 31, 2011:</b>				
Cost	₩	45,314	184,834	230,148
Accumulated depreciation and impairment		-	(41,797)	(41,797)
Carrying amount	₩	45,314	143,037	188,351

(b) Changes in investment property for the year ended December 31, 2010 were as follows:

		In millions of won		
		Land	Buildings	Total
<b>Balance at January 1, 2010:</b>				
Cost	₩	15,385	117,885	133,270
Accumulated depreciation and impairment		-	(29,155)	(29,155)
Carrying amount	₩	15,385	88,730	104,115
<b>Changes:</b>				
Depreciation	₩	-	(3,855)	(3,855)
Impairment		-	(1,437)	(1,437)
Reclassification from assets held for sale		21,165	1,742	22,907
Reclassification to property, plant and equipment		-	(247)	(247)
	₩	21,165	(3,797)	17,368
<b>Balance at December 31, 2010:</b>				
Cost	₩	36,550	121,890	158,440
Accumulated depreciation and impairment		-	(36,957)	(36,957)
Carrying amount	₩	36,550	84,933	121,483

For the year ended December 31, 2010, the Group recognized ₩1,437 million of impairment loss on the investment property transferred from assets held for sale due to the cancellation of a contract.

(c) The amounts recognized in profit or loss from investment property for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Rental income	₩	21,243	17,177
Direct operating expense		(5,013)	(3,855)
Impairment loss		-	(1,437)
	₩	16,230	11,885

(d) The carrying amount and the fair value of investment property as of December 31, 2011 and 2010 were as follows:

		In millions of won			
		2011		2010	
		Fair value	Carrying amount	Fair value	Carrying amount
Land	₩	313,922	45,314	187,620	36,550
Buildings		198,204	143,037	91,498	84,933
	₩	512,126	188,351	279,118	121,483

### 9. EQUITY ACCOUNTED INVESTMENTS

(a) Equity accounted investments as of December 31, 2011 and 2010 are summarized as follows:

Associate	Location	Principal operation	In millions of won, except percentage of ownership			
			Percentage of ownership	2011	2010	Carrying amount
Cosmo Tobacco Co., Ltd.	Mongolia	Manufacturing and selling tobaccos	40.00%	₩ -	40.00%	₩ -
Lite Pharm Tech, Inc.	Korea	Manufacturing medical supplies	25.34%	637	25.34%	645
Korean Carbon Finance, Inc.	Korea	Emissions trading	20.00%	1,013	20.00%	952
JR CR-REIT IV Co., Ltd.	Korea	Selling and renting real estate	49.02%	13,819	-	-
KVG REIT 1 Co., Ltd.	Korea	Selling and renting real estate	29.67%	7,354	-	-
KOCREF REIT 17 Co., Ltd.	Korea	Selling and renting real estate	22.06%	6,872	-	-
JR REIT V Co., Ltd.	Korea	Selling and renting real estate	34.63%	5,635	-	-
				₩ 35,330		₩ 1,597

The Group acquired additional shares of JR CR-REIT IV Co., Ltd., resulting in an increase of the Group's percentage of ownership from 32.68% to 49.02%.

Cosmo Tobacco Co., Ltd. was in the process of liquidation as of December 31, 2011. The Group has discontinued application of the equity method to Cosmo Tobacco Co., Ltd. as the carrying amount of investment in Cosmo Tobacco Co., Ltd. has been reduced to zero due to accumulated deficit.

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(b) Changes in equity accounted investments for the year ended December 31, 2011 were as follows:

Associate	In millions of won				
	Balance at beginning of period	Acquisition	Share of profit or loss of associates	Others	Balance at end of period
Lite Pharm Tech, Inc.	₩ 645	-	(8)	-	637
Korean Carbon Finance, Inc.	952	-	61	-	1,013
JR CR-REIT IV Co., Ltd.	-	3,995	625	9,199	13,819
KVG REIT 1 Co., Ltd.	-	-	284	7,070	7,354
KOCREF REIT 17 Co., Ltd.	-	7,000	81	(209)	6,872
JR REIT V Co., Ltd.	-	5,600	274	(239)	5,635
	₩ 1,597	16,595	1,317	15,821	35,330

The Group reclassified ₩17,300 million of available-for-sale financial assets to equity accounted investments and received ₩1,479 million of dividends from those associates for the year ended December 31, 2011.

(c) Changes in equity accounted investments for the year ended December 31, 2010 were as follows:

Associate	In millions of won				
	Balance at beginning of period	Acquisition	Share of profit or loss of associates	Others	Balance at end of period
Lite Pharm Tech, Inc.	₩ 572	-	(227)	300	645
Korean Carbon Finance, Inc.	1,012	-	(60)	-	952
	₩ 1,584	-	(287)	300	1,597

(d) Summarized financial information of associates as of and for the year ended December 31, 2011 was as follows:

Associate	In millions of won				
	Total assets	Total liabilities	Revenue	Profit or loss	
Lite Pharm Tech, Inc.	₩ 4,041	1,527	1,549	(32)	
Korean Carbon Finance, Inc.	5,158	97	1,143	303	
JR CR-REIT IV Co., Ltd.	65,722	35,658	6,758	1,583	
KVG REIT 1 Co., Ltd.	52,829	28,045	5,540	993	
KOCREF REIT 17 Co., Ltd.	65,749	34,600	128	441	
JR REIT V Co., Ltd.	31,480	15,208	540	831	

(e) Summarized financial information on associates as of and for the year ended December 31, 2010 was as follows:

Associate	In millions of won				
	Total assets	Total liabilities	Revenue	Profit or loss	
Lite Pharm Tech, Inc.	₩ 3,887	1,342	938	(896)	
Korean Carbon Finance, Inc.	4,858	100	1,213	(305)	

## 10. AVAILABLE-FOR-SALE FINANCIAL ASSETS

(a) Changes in available-for-sale financial assets for the years ended December 31, 2011 and 2010 were as follows:

	In millions of won	
	2011	2010
Balance at beginning of year	₩ 315,177	444,040
Acquisition	22,316	39,923
Net changes in fair value before tax	(65,145)	(141,998)
Reclassification to equity accounted investments	(17,300)	-
Reclassification to investment in subsidiaries	(733)	-
Impairment	(3,988)	-
Disposals	(1,927)	(26,788)
Net exchange difference	3	-
Balance at end of year	₩ 248,403	315,177
Statements of financial position:		
- Current	₩ 1,044	1,000
- Non-current	247,359	314,177
	₩ 248,403	315,177

The Group recognized ₩3,988 million of impairment loss on the available-for-sale equity instruments of Migami, Inc. for the year ended December 31, 2011.

(b) Available-for-sale financial assets as of December 31, 2011 and 2010 are summarized as follows:

	In millions of won	
	2011	2010
Available-for-sale debt instruments:		
- Government and municipal bonds	₩ 336	240
- Corporate bonds	2,040	20,340
Total available-for-sale debt instruments	2,376	20,580
Available-for-sale equity instruments:		
Listed		
- YTN Co., Ltd.	23,130	30,839
- Oscotech, Inc.	2,049	1,022
- Shinhan Financial Group Co., Ltd.	159,332	212,042
- Rexahn Pharmaceuticals, Inc.	2,801	8,152
	187,312	252,055
Unlisted		
- Dream Hub PFV Co., Ltd.	12,009	12,732
- Migami, Inc.	-	3,988
- Other unlisted available-for-sale equity instruments	46,706	25,822
	58,715	42,542
Total available-for-sale equity instruments	246,027	294,597
Total available-for-sale financial assets	₩ 248,403	315,177

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

The fair value of Dream Hub PFV Co., Ltd. which does not have a market price in an active market is measured at the value per share determined by the net asset valuation model.

The other unlisted available-for-sale equity instruments that do not have a market price in an active market and whose fair value cannot be reliably measured and available-for-sale debt instruments whose fair value is similar to their carrying amount, are measured at cost.

### 11. LONG-TERM DEPOSITS IN MSA ESCROW FUND

(a) Long-term deposits in MSA Escrow Fund as of December 31, 2011 and 2010 are summarized as follows:

		In millions of won	
		2011	2010
MMF	₩	147,290	74,167
Treasury note		-	58,247
	₩	147,290	132,414

(b) As discussed in note 32 to the consolidated 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. The payments of long-term deposits in MSA Escrow Fund for the years ended December 31, 2011 and 2010 are ₩15,150 million and ₩13,625 million, respectively.

(c) Investment income on long-term deposits in MSA Escrow Fund for the years ended December 31, 2011 and 2010 are ₩6,658 million and ₩4,637 million, respectively.

(d) Long-term deposits in MSA Escrow Fund are measured at quoted prices in an active market.

### 12. TRADE AND OTHER RECEIVABLES

(a) Trade and other receivables as of December 31, 2011 and 2010 are summarized as follows:

		2011		2010	
		Current	Non-current	Current	Non-current
Loans to employees	₩	13,424	32,441	19,300	43,092
Loans		1,917	8,540	898	7,130
Other receivables		62,910	22,281	67,093	-
Guarantee deposits		-	70,853	-	64,318
Accrued income		1,962	-	2,204	-
Trade receivables		753,097	-	536,914	-
	₩	833,310	134,115	626,409	114,540

(b) Trade and other receivables as of December 31, 2011 and 2010 have been reported in the consolidated statements of financial position net of allowances as follows:

		2011		2010	
		Current	Non-current	Current	Non-current
Gross trade and other receivables	₩	849,691	134,115	635,218	114,540
Allowance account:					
- Loans		(199)	-	-	-
- Other receivables		(2,235)	-	(1,934)	-
- Trade receivables		(13,947)	-	(6,875)	-
		(16,381)	-	(8,809)	-
Net trade and other receivables	₩	833,310	134,115	626,409	114,540

(c) Changes in the allowance account for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Balance at beginning of year	₩	8,809	10,237
Business combination		6,904	-
Impairment		1,893	473
Reversal of impairment		(169)	(216)
Write-off		(1,045)	(1,682)
Net exchange difference		(11)	(3)
Balance at end of year	₩	16,381	8,809

Impairment loss and reversal of impairment loss on trade and other receivables are included as part of other expense and income in the consolidated statements of comprehensive income.

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(d) The aging schedule of trade and other receivables which were past due but not impaired as of December 31, 2011 and 2010 is as follows:

		In millions of won	
		2011	2010
Within one month	₩	59,256	48,739
Between one and two months		58,873	64,936
Beyond two months		100,069	17,131
	₩	218,198	130,806

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 Group holds bank guarantees, other guarantees and credit insurance 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 December 31, 2011 and 2010 were as follows:

	Effective interest rate	Current	2011		Effective interest rate	Current	2010	
			Non-current				Non-current	
Loans to employees	3.00~5.68%	₩ 13,422	32,427		3.00~5.68%	₩ 19,287	43,066	
Loans	3.13~7.29%	1,521	4,673		3.29~8.47%	898	3,554	
Other receivables	3.79%	7,997	22,281		-	-	-	
Guarantee deposits	2.50~7.29%	-	67,661		3.00~8.47%	-	61,719	
		₩ 22,940	127,042			₩ 20,185	108,339	

There is no material difference between the carrying amount and their fair value except the above trade and other receivables, due to the short-term duration of the majority of trade and other receivables.

### 13. INVENTORIES

(a) Inventories as of December 31, 2011 and 2010 are summarized as follows:

		In millions of won	
		2011	2010
Merchandise, net of loss on the write-down of inventories	₩	4,797	7,914
Finished goods, net of loss on the write-down of inventories		305,526	238,009
Work-in-progress, net of loss on the write-down of inventories		324,440	312,920
Raw materials, net of loss on the write-down of inventories		871,385	869,053
Supplies		26,158	25,941
By-products		6,738	7,542
Buildings under construction		-	381
Sites for lotting-out construction		-	9,449
Goods-in-transit		33,255	25,825
	₩	1,572,299	1,497,034

(b) The amounts of inventories recognized as an expense for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Cost of sales:</b>			
- Loss on the write-down of inventories	₩	629	164
- Reversal of the write-down of inventories		(55)	-
<b>Other expense:</b>			
- Loss on retirement of inventories		7,270	6,251
	₩	7,844	6,415

### 14. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2011 and 2010 are summarized as follows:

		In millions of won	
		2011	2010
Cash on hand	₩	4,554	5,079
Demand deposits		213,845	110,260
Short-term investment assets		589,332	865,975
	₩	807,731	981,314

Cash equivalents mainly include short-term deposits with an original maturity of three months or less. The carrying amount of cash and cash equivalents approximates their fair value.

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15. PLEDGED ASSETS

(a) The following assets were pledged as collateral for the Group's borrowings and others as of December 31, 2011:

In millions of won					
Asset	Carrying amount	Type	Received amount	Collateralized amount	Lender/Leaseholder
Property, plant and equipment, intangible assets and investment property	₩ 82,776	Short-term borrowings	₩ 21,906		
		Long-term borrowings	10,370	94,946	Hana Bank and 5 others
Investment property	89,705	Leasehold deposits received	6,576	7,469	Metlife Insurance Korea Co., Ltd. and 27 others
	₩ 172,481		₩ 38,852	102,415	

(b) The following assets were pledged as collateral for the Group's borrowings and others as of December 31, 2010:

In millions of won					
Asset	Carrying amount	Type	Received amount	Collateralized amount	Lender/Leaseholder
Property, plant and equipment, and investment property	₩ 67,018	Short-term borrowings	₩ 25,900		
		Long-term borrowings	2,045	60,150	Hana Bank and 2 others
Investment property	32,722	Leasehold deposits received	2,583	3,429	Korea Life Insurance Co., Ltd. and 18 others
	₩ 99,740		₩ 30,528	63,579	

(c) Other financial assets restricted in use as of December 31, 2011 and 2010 were as follows:

In millions of won			
		2011	2010
Security deposits for checking accounts	₩	34	6
Collateral for borrowings		9,677	640
	₩	9,711	646

16. SHARE CAPITAL

(a) Details of share capital as of December 31, 2011 and 2010 were as follows:

			In won, except number of shares	
			2011	2010
Number of ordinary shares:				
- Authorized			800,000,000	800,000,000
- Issued			137,292,497	137,292,497
- Outstanding			125,748,800	127,648,800
Par value	₩		5,000	5,000

The Parent Company has, thus far, reacquired and retired 53,699,400 shares of treasury shares. Accordingly, as of December 31, 2011, the Parent Company's ordinary shares differ from the aggregate par value of issued shares by ₩268,497 million.

(b) Changes in the number of shares for the years ended December 31, 2011 and 2010 were as follows:

	Number of shares					
	2011			2010		
	Ordinary shares	Treasury shares Total	Total	Ordinary shares	Treasury shares Total	Total
Beginning of year	137,292,497	(9,643,697)	127,648,800	137,292,497	(10,093,697)	127,198,800
Reacquisition of treasury shares	-	(2,000,000)	(2,000,000)	-	-	-
Reissuance of treasury shares	-	100,000	100,000	-	450,000	450,000
End of year	137,292,497	(11,543,697)	125,748,800	137,292,497	(9,643,697)	127,648,800

(c) Changes in the other capital surplus for the years ended December 31, 2011 and 2010 were as follows:

In millions of won			
		2011	2010
Balance at beginning of year	₩	5,333	5,321
Issuance of subsidiaries' share capital		-	12
Balance at end of year	₩	5,333	5,333

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### 17. TREASURY SHARES

(a) Changes in the treasury shares for the years ended December 31, 2011 and 2010 were as follows:

	In millions of won, except number of shares			
	2011		2010	
	Number of shares	Carrying amount	Number of shares	Carrying amount
Balance at beginning of year	9,643,697	₩ 216,827	10,093,697	₩ 226,945
Reacquisition of treasury shares	2,000,000	129,671	-	-
Reissuance of treasury shares	(100,000)	(2,976)	(450,000)	(10,118)
Balance at end of year	11,543,697	₩ 343,522	9,643,697	₩ 216,827

(b) Changes in gain on reissuance of treasury shares for the years ended December 31, 2011 and 2010 were as follows:

	2011		2010	
		In millions of won		In millions of won
Balance at beginning of year	₩	482,129		468,274
Gain on reissuance of treasury shares before tax		5,004		18,278
Less: tax at 24.2%		(1,211)		(4,423)
Gain on reissuance of treasury shares, net of tax		3,793		13,855
Balance at end of year	₩	485,922		482,129

### 18. RESERVES

(a) Details of reserves as of December 31, 2011 and 2010 were as follows:

	2011		2010	
		In millions of won		In millions of won
<b>Accumulated other comprehensive income:</b>				
Available-for-sale financial assets reserve	₩	(31,855)		18,034
Exchange differences on translating foreign operations		(15,502)		(5,476)
<b>Reserves:</b>				
Legal reserve		602,937		602,937
Voluntary reserve		2,107,732		1,563,732
	₩	2,663,312		2,179,227

(b) Available-for-sale financial assets reserve as of December 31, 2011 and 2010 are summarized as follows:

	2011		2010	
		In millions of won		In millions of won
Available-for-sale financial assets reserve before tax	₩	(42,024)		23,121
Tax effect		10,169		(5,087)
	₩	(31,855)		18,034

### (c) Legal Reserve

The Korean Commercial Code requires the Parent 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.

(d) Details of the Group's voluntary reserve as of December 31, 2011 and 2010 were as follows:

	2011		2010	
		In millions of won		In millions of won
Reserve for business rationalization	₩	12,851		12,851
Reserve for research and human resource development		60,000		60,000
Reserve for business expansion		698,881		698,881
Unconditional reserve		1,336,000		792,000
	₩	2,107,732		1,563,732

#### Reserve for Business Rationalization

Until December 10, 2002 under the *Special Tax Treatment Control Law*, investment tax credits were allowed for certain investments. The Parent 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 Parent 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 Business Expansion

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

#### Other Reserves

Reserve for research and human resource development was appropriated in order to utilize certain tax deduction benefits through the early recognition of future expenditures. This reserve is restored to retained earnings in accordance with the relevant tax laws. Such reserve is taken back into taxable income in the year of restoration. Reserves without specific purposes are restored to retained earnings by a resolution at a general meeting of shareholders.

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### 19. RETAINED EARNINGS

Changes in retained earnings for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Balance at beginning of year	₩	1,151,358	704,012
Transfer from reserve for research and human resource development		-	15,000
Transfer from reserve for loss on reissuance of treasury shares		-	26,646
Transfer to reserve for research and human resource development		-	(60,000)
Transfer to unconditional reserve		(544,000)	(203,000)
Dividends		(382,946)	(356,157)
Profit for the year		816,929	1,030,789
- Less: non-controlling interests		(871)	1,035
Actuarial losses, net of tax		(19,449)	(7,590)
- Less: non-controlling interests		1,105	623
Balance at end of year	₩	1,022,126	1,151,358

### 20. STATEMENTS OF APPROPRIATION OF RETAINED EARNINGS

Statements of appropriation of retained earnings of the Parent Company for the years ended December 31, 2011 and 2010 are as follows:

Date of appropriation for 2011: February 24, 2012

Date of appropriation for 2010: March 4, 2011

		In millions of won	
		2011	2010
<b>Unappropriated retained earnings:</b>			
Balance at beginning of year	₩	2,194	2,452
Profit for the year		775,937	931,127
Actuarial losses, net of tax		(14,393)	(4,439)
		763,738	929,140
Transfer from voluntary reserves		-	-
Unappropriated retained earnings available for appropriation		763,738	929,140
<b>Appropriation of retained earnings:</b>			
Dividends (note 35)		(402,396)	(382,946)
Unconditional reserve		(359,000)	(544,000)
		(761,396)	(926,946)
Unappropriated retained earnings to be carried over to subsequent year	₩	2,342	2,194

### 21. LONG-TERM BORROWINGS

(a) Long-term borrowings as of December 31, 2011 and 2010 are summarized as follows:

Lender	Annual interest rate		2011		2010	
			Current	Non-current	Current	Non-current
Hana Bank	3.80~4.02%	₩	503	1,036	506	1,540
National Agricultural Cooperative Federation	2.25%		-	756	-	-
Korea Development Bank	3.92~7.57%		46	8,428	-	-
SMI 22 <sup>nd</sup> ABS Securitization Specialty Co.	8.10%		1,500	2,500	-	-
Small and Medium Business Corporation	3.70%		119	238	-	-
Private convertible bond	11.11%		958	-	-	-
Foreign currency convertible bond	9.50%		-	12,577	-	-
Convertible redeemable preference shares	-		-	12,312	-	-
		₩	3,126	37,847	506	1,540

As of December 31, 2011, Kang, Seok-Chang, the former owner of Somang Cosmetics Co., Ltd., has guaranteed the Group's borrowings from Korea Development Bank in the amount of ₩474 million. In addition, Gwak, Tae-Hwan, the former owner of Mazence, Inc. has guaranteed the Group's borrowings from Small and Medium Business Corporation.

(b) Repayment schedule for long-term borrowings as of December 31, 2011 is as follows:

	In millions of won	
	₩	Amount
Within one year	₩	3,126
Between one and two years		1,958
Between two and three years		9,416
Between three and four years		327
Beyond four years		26,146
	₩	40,973

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**22. TRADE AND OTHER PAYABLES**

(a) Trade and other payables as of December 31, 2011 and 2010 are summarized as follows:

	In millions of won			
	2011		2010	
	Current	Non-current	Current	Non-current
Leasehold deposits received	₩ 154	25,069	60	21,697
Trade payables	81,938	-	44,381	-
Withholdings	137,344	644	126,793	1,183
Accrued expenses	131,775	-	110,866	-
Other payables	71,523	318	19,111	-
	₩ 422,734	26,031	301,211	22,880

(b) Details of trade and other payables that are measured at amortized cost as of December 31, 2011 and 2010 were as follows:

	In millions of won					
	2011			2010		
	Effective interest rate	Current	Non-current	Effective interest rate	Current	Non-current
Leasehold deposits received	3.00~5.68%	₩ -	25,069	3.00~5.68%	₩ -	21,697

There is no material difference between the carrying amount and their fair value except the above trade and other payables, due to the short-term duration of the majority of trade and other payables.

**23. SHORT-TERM BORROWINGS**

Short-term borrowings as of December 31, 2011 and 2010 are summarized as follows:

	Annual interest rate		In millions of won	
			2011	2010
<b>Customer credit contracts:</b>				
National Agricultural Cooperative Federation	1.54~7.23%	₩	6,351	7,042
Citibank Korea Inc. and others	3M CD+1.25~2.50%		28,829	25,918
<b>General purpose borrowings:</b>				
Hana Bank and others	0.00~12.00%		47,656	33,547
		₩	82,836	66,507

The Group has entered into a customer credit contract with National Agricultural Cooperative Federation ("NACF") and other financial institutions. The financial institutions pay past-due trade receivables for customers and the Group has provided guarantees to the financial institutions for customers. The amount paid by the financial institutions is recognized as short-term borrowings in the consolidated statements of financial position.

Kang, Seok-Chang, the former owner of Somang Cosmetics Co., Ltd., has guaranteed part of the Group's general purpose borrowings in the amount of ₩16,274 million.

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### 24. RETIREMENT BENEFITS PLAN

The Group operates both defined benefit and defined contribution plans. According to these defined benefit plans, the Group pays retirement benefits calculated under the plan's benefit formula at the time employees leave the Group. The defined benefit obligations are calculated annually by independent actuaries using the projected unit credit method.

(a) The components of retirement benefit for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Defined benefit plan:</b>			
- Current service costs	₩	32,401	34,296
- Interest costs		8,029	8,758
- Expected returns on plan assets		(5,850)	(7,364)
- Gains on the settlement of the plan		489	287
		35,069	35,977
<b>Defined contribution plan:</b>			
- Contributions recognized as expense		1,194	960
	₩	36,263	36,937

The Group recognized contributions payable amounting to ₩83 million as other payables (accrued expenses) in the consolidated statement of financial position as of December 31, 2010.

The Group recognized termination benefits amounting to ₩3,573 million and ₩50,002 million as an expense for the years ended December 31, 2011 and 2010, respectively. With regard to the termination benefits, the Group recognized other payables (accrued expenses) amounting to ₩1,695 million in the consolidated statement of financial position as of December 31, 2010.

(b) Changes in defined benefit liabilities for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Balance at beginning of year</b>	₩	48,324	35,445
Business combination		5,688	-
Retirement benefits		35,069	35,977
Actuarial losses before tax		24,907	9,353
Payments into plan assets		(22,929)	(17,558)
Payments, including the amount transferred to the defined contribution plan		(7,925)	(14,420)
Changes in accrued expenses		(49)	(470)
Net exchange difference		(3)	(3)
<b>Balance at end of year</b>	₩	83,082	48,324
<b>Statements of financial position:</b>			
- Present value of retirement benefit obligations	₩	233,377	176,811
- Fair value of plan assets		(150,295)	(128,487)
<b>Defined benefit liabilities</b>	₩	83,082	48,324

(c) Changes in defined benefit obligations for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Balance at beginning of year</b>	₩	176,811	163,006
Business combination		8,330	-
Current service costs		32,401	34,296
Interest costs		8,029	8,758
Losses on the settlement of the plan		489	287
Actuarial losses before tax		24,648	8,745
Payments, including the amount transferred to the defined contribution plan		(17,516)	(36,784)
Changes in accrued expenses		188	(1,494)
Net exchange difference		(3)	(3)
<b>Balance at end of year</b>	₩	233,377	176,811

(d) Changes in plan assets for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Balance at beginning of year</b>	₩	128,487	127,561
Business combination		2,642	-
Expected return on plan assets		5,850	7,364
Actuarial losses before tax		(259)	(608)
Payments into plan assets		22,929	17,558
Payments, including the amount transferred to the defined contribution plan		(9,591)	(22,364)
Changes in accrued expenses		237	(1,024)
<b>Balance at end of year</b>	₩	150,295	128,487

Actual returns on plan assets for the years ended December 31, 2011 and 2010 are ₩5,591 million and ₩6,756 million, respectively.

Expected rates of return are determined taking into account the current level of expected returns on risk-free investments, the historical level of risk premium associated with other invested assets, and the expectations for future returns on such assets.

(e) The amount of actuarial losses for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Actuarial losses before tax	₩	(24,907)	(9,353)
Tax effect		5,458	1,763
	₩	(19,449)	(7,590)

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(f) The components of plan assets as of December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Short-term trading financial assets	₩	86,346	94,192
Available-for-sale financial assets		57,814	33,680
Others		6,135	615
	₩	150,295	128,487

As of December 31, 2011 and 2010, short-term trading financial assets include severance insurance of ₩298 million and ₩3,272 million, respectively, which continue to be covered by the existing retirement benefits plan.

(g) The principal actuarial assumptions as of December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Rate of salary increases		3.34%~8.00%	3.00%~6.00%
Discount rate		3.80%~8.25%	4.30%~5.00%
Expected rate of return on plan assets		3.20%~6.00%	3.78%~5.44%

For the purpose of calculating present value of the defined benefit obligations, the Group used the discount rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds consistent with the currency and estimated term of the defined benefit obligations.

(h) Sensitivities in respect of the key assumptions used to measure the defined benefit plan were as follows:

		In millions of won	
		1 percentage point increase	1 percentage point decrease
<b>Rate of salary increases:</b>			
- Increase (decrease) in defined benefit obligations	₩	22,612	(18,911)
- Increase (decrease) in retirement benefits before tax		4,379	(3,832)
<b>Discount rate:</b>			
- Increase (decrease) in defined benefit obligations		(19,923)	24,242
- Increase (decrease) in retirement benefits before tax		(2,007)	2,287
<b>Expected rate of return on plan assets:</b>			
- Increase (decrease) in retirement benefits before tax		(1,300)	1,300

The effect on defined benefit obligations is as of December 31, 2011. The effect on retirement benefits before tax is for the year ended December 31, 2011.

## 25. DEFERRED REVENUE

Changes in deferred revenue included in long-term advance receipts for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Balance at beginning of year	₩	10,420	9,682
Revenue deferred		11,211	5,672
Revenue recognized		(9,125)	(4,934)
Balance at end of year	₩	12,506	10,420

## 26. PROFIT FROM OPERATIONS

(a) Employee benefit costs for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Salaries	₩	463,684	387,501
Retirement benefits		36,263	36,937
Termination benefits		3,573	50,002
Employee welfare		52,644	42,988
	₩	556,164	517,428

(b) Depreciation and amortization for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Depreciation	₩	152,885	147,673
Amortization		4,494	1,324
	₩	157,379	148,997

(c) Details of other income for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Foreign currency transaction gain	₩	35,746	21,590
Foreign currency translation gain		17,966	1,717
Reversal of impairment loss on trade and other receivables		169	216
Gain on sale of investments in subsidiaries		1,139	-
Gain on sale of equity accounted investments		-	300
Gain on sale of property, plant and equipment		45,852	101,886
Gain on sale of intangible assets		7,016	24
Others		11,179	13,874
	₩	119,067	139,607

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(d) Details of selling expenses for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Salaries	₩	199,875	167,462
Retirement and termination benefits		17,308	36,823
Employee welfare		24,573	21,775
Travel		8,324	8,070
Communications		2,612	2,426
Utilities		5,435	5,443
Taxes and dues		14,431	15,497
Supplies		2,819	1,919
Rent		18,804	16,113
Depreciation		28,677	33,328
Amortization		3,238	320
Repairs and maintenance		5,880	5,826
Vehicles		8,696	7,264
Insurance		1,590	995
Commissions		126,939	81,570
Freight and custody		41,737	35,827
Conferences		2,030	1,612
Advertising		185,806	133,981
Training		2,440	3,128
Prizes and rewards		2,200	1,492
Normal research and development		11,827	11,652
	₩	715,241	592,523

(e) Details of general and administrative expenses for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Salaries	₩	94,118	71,394
Retirement and termination benefits		8,021	18,637
Employee welfare		11,055	6,392
Travel		3,961	2,815
Communications		2,663	2,751
Utilities		2,084	1,642
Taxes and dues		1,673	1,995
Supplies		1,288	1,623
Rent		8,965	4,948
Depreciation		16,092	14,376
Amortization		1,046	899
Repairs and maintenance		2,986	2,249
Vehicles		1,865	1,613
Insurance		464	291
Commissions		42,817	63,972
Freight and custody		1,852	1,013
Conferences		2,416	1,895
Advertising		80,267	111,821
Training		5,558	7,030
Prizes and rewards		1,533	1,277
Normal research and development		17,532	9,898
	₩	308,256	328,531

(f) Details of other expenses for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Foreign currency transaction loss	₩	32,210	23,880
Foreign currency translation loss		6,706	5,755
Impairment loss on trade receivables		1,727	410
Impairment loss on other receivables		166	63
Donations		18,531	30,934
Loss on sale of property, plant and equipment		3,493	2,386
Loss on sale of intangible assets		647	159
Impairment loss on intangible assets		15,914	3,681
Impairment loss on investment property		-	1,437
Loss on retirement of inventories		7,270	6,251
Others		3,652	5,721
	₩	90,316	80,677

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27. NET FINANCE INCOME

(a) Details of net finance income for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Financial cost:</b>			
- Interest costs	₩	4,233	3,255
- Loss on sale of available-for-sale financial assets		-	1,214
- Impairment loss on available-for-sale financial assets		3,988	-
		8,221	4,469
<b>Financial income:</b>			
- Interest income		(34,790)	(23,541)
- Dividend income		(5,248)	(2,056)
- Investment income on long-term deposits in MSA Escrow Fund		(6,658)	(4,637)
- Gain on sale of available-for-sale financial assets		(643)	(240,104)
		(47,339)	(270,338)
<b>Net finance income</b>	₩	(39,118)	(265,869)

(b) Details of interest costs for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Related financial liabilities:</b>			
- Borrowings	₩	3,306	2,396
- Trade and other payables		927	549
- Others		-	310
	₩	4,233	3,255

(c) Details of interest income for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Related financial assets:</b>			
- Deposits	₩	32,632	19,988
- Available-for-sale financial assets		69	362
- Trade and other receivables		2,089	3,191
	₩	34,790	23,541

(d) Details of finance income recognized in other comprehensive income for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won					
		2011			2010		
		Before tax	Tax effect	Net of tax	Before tax	Tax effect	Net of tax
<b>Available-for-sale financial assets:</b>							
Net changes in fair value	₩	(65,145)	15,256	(49,889)	96,892	(21,317)	75,575
Less: reclassified to profit or loss		-	-	-	(238,890)	52,556	(186,334)
	₩	(65,145)	15,256	(49,889)	(141,998)	31,239	(110,759)

28. INCOME TAX

(a) The Group was subject to income tax on taxable income at the following normal tax rates.

Taxable income	Tax rate		
	2010	2011	Thereafter
Up to ₩200 million	11.0%	11.0%	11.0%
₩200 million ~ ₩20 billion	24.2%	24.2%	22.0%
Over ₩20 billion	24.2%	24.2%	24.2%

In December 2011, the Korean government changed the corporate income tax rate (including resident tax) for taxable income exceeding ₩20 billion from 22.0% to 24.2% prospectively from 2012.

(b) The components of income tax expense for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Current income tax expense	₩	291,009	347,955
Adjustments recognized			
in the period for current tax of prior periods		4,018	109
Changes in temporary difference		29,624	(2,740)
<b>Total income tax expense</b>		324,651	345,324
Tax expense recognized outside profit or loss		19,484	29,562
<b>Income tax expense</b>	₩	344,135	374,886

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(c) Current and deferred tax expense that were recognized outside profit or loss for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
<b>Current:</b>			
- Gain on reissuance of treasury shares	₩	(1,211)	(4,423)
- Actuarial losses		5,458	1,763
		4,247	(2,660)
<b>Deferred:</b>			
- Net changes in fair value of available-for-sale financial assets		15,256	31,239
- Exchange differences on translating foreign operations		(19)	983
		15,237	32,222
<b>Tax expense recognized outside profit or loss</b>	₩	19,484	29,562

Income tax related to gain on reissuance of treasury shares was recognized directly in equity and income tax related to actuarial losses, net changes in fair value of available-for-sale financial assets and exchange differences on translating foreign operations was recognized in other comprehensive income.

(d) The income tax expense calculated by applying statutory tax rates to the Group's profit before tax for the year differs from the actual tax expense in the consolidated statements of comprehensive income for the years ended December 31, 2011 and 2010 for the following reasons:

		In millions of won, except tax information	
		2011	2010
<b>Profit before tax</b>	₩	1,161,064	1,405,675
Normal tax rate		24.2%	24.2%
Expense for income tax at normal tax rate		280,951	340,147
<b>Adjustment:</b>			
- Tax effects of permanent differences		9,233	4,257
- Investment tax credits		(3,339)	(1,984)
- Additional income tax for prior period		3,927	148
- Deferred tax expense relating to changes in tax rates		28,161	-
- Tax effects of profit of subsidiaries		25,955	30,992
- Others		(753)	1,326
<b>Income tax expense</b>	₩	344,135	374,886
<b>Effective tax rate</b>		29.6%	26.7%

(e) Deferred tax expense (benefit) relating to the origination and reversal of temporary differences for the years ended December 31, 2011 and 2010 were as follows:

		In millions of won	
		2011	2010
Deferred tax liabilities at end of year	₩	(212,102)	(156,436)
Business combination		(26,042)	-
Deferred tax liabilities at beginning of year		(156,436)	(159,176)
<b>Deferred tax expense (benefit)</b>	₩	29,624	(2,740)

(f) Deferred tax assets and liabilities are measured using the tax rate to be applied for the year in which temporary differences are expected to be realized.

(g) The net deferred tax liabilities are reflected in the consolidated statements of financial position after offsetting assets and liabilities where there is a legally enforceable right to offset current tax assets and liabilities and where the deferred income tax relates to the same fiscal authority.

(h) Changes in deferred tax assets and liabilities for the year ended December 31, 2011 were as follows:

		In millions of won					
		Balance at beginning of year	Acquisition as part of business combination	Credited to profit (charged to loss)	Charged to other comprehensive income	Changes in tax rates	Balance at end of year
Available-for-sale							
financial assets	₩	9,861	-	877	-	1,074	11,812
Accrued expense		20,708	138	2,562	-	1,917	25,325
Defined benefit liabilities		966	204	1,503	-	244	2,917
Undistributed earnings							
of associates and subsidiaries		(172,123)	-	(15,268)	-	(29,286)	(216,677)
Foreign currency translations		1,313	86	(1,308)	-	-	91
Treasury shares		(8,183)	-	70	-	(811)	(8,924)
Changes in fair value							
of available-for-sale							
financial assets		(5,087)	-	-	15,256	-	10,169
Voluntary reserve		(9,190)	(361)	(10,997)	-	(1,320)	(21,868)
Provision for							
advanced depreciation		(4,722)	-	-	-	(472)	(5,194)
Others		10,021	(26,109)	5,861	(19)	493	(9,753)
	₩	(156,436)	(26,042)	(16,700)	15,237	(28,161)	(212,102)

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(i) Changes in deferred tax assets and liabilities for the year ended December 31, 2010 were as follows:

	In millions of won			
	Balance at beginning of year	Credited to profit (charged to loss)	Charged to other comprehensive income	Balance at end of year
Available-for-sale financial assets	₩ 9,448	413	-	9,861
Accrued expense	22,917	(2,209)	-	20,708
Donations in excess of tax limit	89	(89)	-	-
Defined benefit liabilities	(1,284)	2,250	-	966
Undistributed earnings				
of associates and subsidiaries	(141,131)	(30,992)	-	(172,123)
Foreign currency translations	3,907	(2,594)	-	1,313
Treasury shares	(8,565)	382	-	(8,183)
Changes in fair value of				
available-for-sale financial assets	(36,326)	-	31,239	(5,087)
Voluntary reserve	(16,348)	7,158	-	(9,190)
Provision for advanced depreciation	(4,722)	-	-	(4,722)
Others	12,839	(3,801)	983	10,021
	₩ (159,176)	(29,482)	32,222	(156,436)

(j) As of December 31, 2011 and 2010, the aggregate amounts of temporary differences associated with undistributed earnings of subsidiaries for which deferred tax liabilities have not been recognized were ₩15,953 million and ₩4,216 million, respectively.

(k) The income tax payable and income tax refund before offsetting as of December 31, 2011 and 2010 were as follows:

	In millions of won		
		2011	2010
Income tax payable	₩	292,361	347,956
Income tax refund		(128,795)	(125,185)
	₩	163,566	222,771

### 29. EARNINGS PER SHARE

Basic and diluted earnings per share for the years ended December 31, 2011 and 2010 were as follows:

	In millions of won, except share information		
		2011	2010
Profit attributable to owners of the Parent Company	₩	816,058	1,031,824
Weighted average number of ordinary shares outstanding		126,505,112	127,251,814
<b>Basic and diluted earnings per share in won</b>	₩	6,451	8,109

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

### 30. TRANSACTIONS AND BALANCES WITH RELATED COMPANIES

(a) Details of parent and subsidiary relationships as of December 31, 2011 and 2010 were as follows:

Subsidiary	Location	Next most senior parent	Percentage of ownership					
			2011			2010		
			Parent	Subsidiary	Total	Parent	Subsidiary	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. <sup>(*)1</sup>	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	99.90%	-	99.90%	99.90%	-	99.90%
KT&G Pars	Iran	KT&G Corporation	99.99%	-	99.99%	99.99%	-	99.99%
KT&G Rus LLC.	Russia	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
KG Life & Gin Co., Ltd. <sup>(*)2</sup>	Korea	KT&G Corporation	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Bio Corp.	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%
Purpleland								
Development Co., Ltd. <sup>(*)3</sup>	Korea	KT&G Corporation	-	-	-	100.00%	-	100.00%
Jilin Hanzheng								
Ginseng Co., Ltd. <sup>(*)4</sup>	China	KT&G Corporation	100.00%	-	100.00%	-	-	-
Somang								
Cosmetics Co., Ltd. <sup>(*)5</sup>	Korea	KT&G Corporation	60.00%	-	60.00%	-	-	-
Rosee	Korea	Somang						
Cosmetics Co., Ltd. <sup>(*)5</sup>		Cosmetics Co., Ltd.	-	100.00%	100.00%	-	-	-
Renzoluc Pte., Ltd. <sup>(*)6</sup>	Singapore	KT&G Corporation	100.00%	-	100.00%	-	-	-
PT Trisakti								
Purwosari Makmur <sup>(*)6</sup>	Indonesia	Renzoluc Pte., Ltd.	-	51.00%	51.00%	-	-	-
PT Sentosa	Indonesia	PT Trisakti						
Ababi Purwosari <sup>(*)6</sup>		Purwosari Makmur	-	99.24%	99.24%	-	-	-
PT Purindo Ilufa <sup>(*)6</sup>	Indonesia	PT Trisakti						
Purwosari Makmur		Purwosari Makmur	-	100.00%	100.00%	-	-	-
Mazence, Inc. <sup>(*)7</sup>	Korea	KT&G Corporation	59.48%	-	59.48%	-	-	-
Yebon Nongwon								
Agriculture Co., Ltd. <sup>(*)8</sup>	Korea	KT&G Corporation	90.00%	-	90.00%	-	-	-
Korea Ginseng HK, Ltd. <sup>(*)9</sup>	HongKong	Korea						
Ginseng Corporation		Ginseng Corporation	-	-	-	-	99.99%	99.99%
Cheong Kwan Jang	Taiwan	Korea						
Taiwan Corporation		Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korean Red	USA	Korea						
Ginseng Corp., Inc.		Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng (China) Corp.	China	Korea						
Ginseng Corporation		Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng Corporation Japan <sup>(*)10</sup>	Japan	Korea						
Ginseng Corporation		Ginseng Corporation	-	100.00%	100.00%	-	-	-

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- (\*)1 Tae-a Industry Co., Ltd. increased paid-in capital by way of shareholder allocation in 2011, resulting in an increase of the Parent Company's investments in the investee by ₩1,500 million.
- (\*)2 KGC Life & Gin Co., Ltd. increased paid-in capital by way of shareholder allocation in 2011 resulting in an increase of the Parent Company's investments in the investee by ₩9,000 million.
- (\*)3 Purpleland Development Co., Ltd. was liquidated in 2011.
- (\*)4 The Parent Company established Jilin Hanzheng Ginseng Co., Ltd. in 2011.
- (\*)5 The Parent Company obtained control of Somang Cosmetics Co., Ltd. by acquiring a 60.00% share of the investee in 2011.
- (\*)6 The Parent Company obtained control of Renzoluc Pte., Ltd. by acquiring a 100.00% share of the investee in 2011.
- (\*)7 The Parent Company obtained control of Mazence, Inc. by contributing ₩10,000 million of cash and ₩20,499 million of intangible assets to the investee as capital contribution in 2011. Accordingly, ₩733 million of available-for-sale financial assets was reclassified to investments in subsidiaries.
- (\*)8 The Parent Company established Yebon Nongwon Agriculture Co., Ltd. with a capital contribution of ₩90 million, obtaining a 90.00% share of the investee in 2011.
- (\*)9 Korea Ginseng HK, Ltd. was liquidated in 2011.
- (\*)10 Korea Ginseng Corporation, which is a subsidiary of the Parent Company, established Korea Ginseng Corporation Japan in 2011.

(b) Summarized financial information of significant subsidiaries as of and for the year ended December 31, 2011 was as follows:

	₩	In millions of won				
		Total assets	Total liabilities	Revenue	Profit or loss	Total comprehensive income
Korea Ginseng Corporation		1,148,079	130,554	940,081	156,352	153,854
Yungjin Pharm. Ind. Co., Ltd.		157,787	67,907	112,105	2,581	246
Tae-a Industry Co., Ltd.		14,195	3,023	16,088	881	755
KT&G Tutun Mamulleri						
Sanayi ve Ticaret A.S.		51,975	25,300	11,780	(4,953)	(11,287)
KT&G Pars		36,160	33,894	16,688	(1,265)	(1,618)
KT&G Rus LLC.		165,711	57,481	56,227	9,710	5,494
KG Life & Gin Co., Ltd.		26,940	8,621	20,042	(12,923)	(12,940)
Global Trading, Inc.		28,872	21,539	133,785	2,473	2,634
Jilin Hanzheng Ginseng Co., Ltd.		37,246	14,075	-	(2,022)	(76)
Cheong Kwan Jang Taiwan Corporation		20,161	18,361	35,390	(27)	(73)
Korean Red Ginseng Corp., Inc.		7,111	3,774	7,552	69	113
Korea Ginseng (China) Corp.		40,505	30,567	43,238	1,257	1,810
Korea Ginseng Corporation Japan		9,486	847	459	(2,833)	(1,940)

(c) Summarized financial information of significant subsidiaries as of and for the year ended December 31, 2010 was as follows:

	₩	In millions of won				
		Total assets	Total liabilities	Revenue	Profit or loss	Total comprehensive income
Korea Ginseng Corporation		1,028,406	114,735	842,757	175,605	173,959
Yungjin Pharm. Ind. Co., Ltd.		147,781	58,147	116,317	(2,309)	(3,647)
Tae-a Industry Co., Ltd.		15,488	6,572	13,312	69	(63)
KT&G Tutun Mamulleri						
Sanayi ve Ticaret A.S.		56,299	18,336	8,352	(2,018)	(4,110)
KT&G Pars		28,670	24,784	8,380	(677)	(1,030)
KT&G Rus LLC.		112,422	9,685	-	(1,955)	(4,869)
KG Life & Gin Co., Ltd.		24,903	2,596	9,604	(831)	(864)
Global Trading, Inc.		22,541	17,841	3,113	(57)	(213)
Cheong Kwan Jang Taiwan Corporation		11,223	9,350	17,937	696	822
Korean Red Ginseng Corp., Inc.		5,745	2,522	4,677	(71)	(101)
Korea Ginseng (China) Corp.		17,528	9,399	2,969	(314)	(264)

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(d) Significant transactions which occurred in the normal course of business with related companies for the years ended December 31, 2011 and 2010 are summarized as follows:

		In millions of won	
Sales company	Purchase company	2011	2010
KT&G Corporation	Korea Ginseng Corporation	₩ 4,856	4,670
KT&G Corporation	Yungjin Pharm. Ind. Co., Ltd.	331	225
KT&G Corporation	Tae-a Industry Co., Ltd.	11	14
KT&G Corporation	KGC Life & Gin Co., Ltd.	1,527	22
KT&G Corporation	Purpleland Development Co., Ltd.	7	4
KT&G Corporation	KT&G Tutun Mamulleri		
	Sanayi ve Ticaret A.S.	6,012	4,176
KT&G Corporation	KT&G Pars	8,500	2,590
KT&G Corporation	KT&G Rus LLC.	23,420	6,557
KT&G Corporation	Global Trading, Inc.	33,355	6,545
KT&G Corporation	Jilin Hanzheng Ginseng Co., Ltd.	44	-
KT&G Corporation	Somang Cosmetics Co., Ltd.	2	-
Korea Ginseng Corporation	KT&G Corporation	2,286	1,702
Korea Ginseng Corporation	Yungjin Pharm. Ind. Co., Ltd.	1,923	1,269
Korea Ginseng Corporation	Tae-a Industry Co., Ltd.	60	24
Korea Ginseng Corporation	Korea Ginseng HK, Ltd.	-	8,741
Korea Ginseng Corporation	Cheong Kwan Jang		
	Taiwan Corporation	32,762	18,408
Korea Ginseng Corporation	Korea Red Ginseng Corporation	7,142	4,197
Korea Ginseng Corporation	Korea Ginseng (China) Corp.	40,030	9,369
Korea Ginseng Corporation	Korea Ginseng Corporation Japan	1,070	-
Korea Ginseng Corporation	KGC Life & Gin Co., Ltd.	8,854	6,792
Korea Ginseng Corporation	Somang Cosmetics Co., Ltd.	79	-
Yungjin Pharm. Ind. Co., Ltd.	KT&G Corporation	30	-
Yungjin Pharm. Ind. Co., Ltd.	Korea Ginseng Corporation	4,715	-
Tae-a Industry Co., Ltd.	KT&G Corporation	16,088	13,312
KGC Life & Gin Co., Ltd.	KT&G Corporation	451	-
KGC Life & Gin Co., Ltd.	Somang Cosmetics Co., Ltd.	334	-
KGC Life & Gin Co., Ltd.	Tae-a Industry Co., Ltd.	5	-
KGC Life & Gin Co., Ltd.	Korea Ginseng Corporation	1,931	-
Somang Cosmetics Co., Ltd.	KT&G Corporation	130	-
Somang Cosmetics Co., Ltd.	Rosee Cosmetics Co., Ltd.	930	-
Somang Cosmetics Co., Ltd.	Tae-a Industry Co., Ltd.	3	-
Somang Cosmetics Co., Ltd.	Korea Ginseng Corporation	78	-
Somang Cosmetics Co., Ltd.	KGC Life & Gin Co., Ltd.	8	-
Rosee Cosmetics Co., Ltd.	Somang Cosmetics Co., Ltd.	403	-
KT&G Tutun Mamulleri			
	Sanayi ve Ticaret A.S.	144	1,738
	KT&G Pars		
		₩ 197,521	90,355

The Parent Company received dividends from Korea Ginseng Corporation, which is a subsidiary of the Parent Company, amounting to ₩50,000 million and ₩30,000 million for the years ended December 31, 2011 and 2010, respectively.

The above intra-group transactions are eliminated in preparing the consolidated financial statements.

(e) Account balances with related companies as of December 31, 2011 and 2010 were as follows:

		In millions of won	
Creditor	Debtor	2011	2010
KT&G Corporation	KT&G Tutun Mamulleri		
	Sanayi ve Ticaret A.S.	23,084	17,642
KT&G Corporation	KT&G Pars	30,499	22,114
KT&G Corporation	KT&G Rus LLC.	41,031	8,159
KT&G Corporation	Global Trading, Inc.	14,574	11,248
KT&G Corporation	Renzoluc Pte., Ltd.	64,045	-
KT&G Corporation	Jilin Hanzheng Ginseng Co., Ltd.	9,084	-
KT&G Corporation	Somang Cosmetics Co., Ltd.	2	-
Korea Ginseng Corporation	KT&G Corporation	2,414	2,289
Korea Ginseng Corporation	Yungjin Pharm. Ind. Co., Ltd.	990	330
Korea Ginseng Corporation	Cheong Kwan Jang Taiwan Corporation	17,567	9,288
Korea Ginseng Corporation	Korea Red Ginseng Corp., Inc.	3,310	2,284
Korea Ginseng Corporation	Korea Ginseng (China) Corp.	26,448	8,641
Korea Ginseng Corporation	Korea Ginseng Japan	836	-
Korea Ginseng Corporation	KGC Life & Gin Co., Ltd.	2,253	1,023
Korea Ginseng Corporation	Somang Cosmetics Co., Ltd.	11	-
Yungjin Pharm. Ind. Co., Ltd.	Korea Ginseng Corporation	943	212
KGC Life & Gin Co., Ltd.	KT&G Corporation	192	-
KGC Life & Gin Co., Ltd.	Korea Ginseng Corporation	2,170	-
KGC Life & Gin Co., Ltd.	Somang Cosmetics Co., Ltd.	187	-
Somang Cosmetics Co., Ltd.	Rosee Cosmetics Co., Ltd.	2,431	-
Rosee Cosmetics Co., Ltd.	Somang Cosmetics Co., Ltd.	583	-
Korea Ginseng HK, Ltd.	Korea Ginseng Corporation	-	2,939
		₩ 242,654	86,169

The above intra-group balances are eliminated in preparing the consolidated financial statements.

(f) Details of guarantees provided for related companies as of December 31, 2011 and 2010 were as follows:

			In millions of won and thousands of euro			
Guarantee provider	Guarantee recipient	Type of guarantee	2011		2010	
			Limit	Exercise	Limit	Exercise
KT&G Corporation	KT&G Rus LLC.	Guarantee on foreign currency letter of credit opened	₩ -	-	€ 2,063	2,063
Somang Cosmetics Co., Ltd.	Rosee Cosmetics Co., Ltd.	General working capital and others	2,380	1,980	-	-
Kang, Seok-Chang	Somang Cosmetics Co., Ltd.	General working capital and others	21,175	16,748	-	-
			₩ 23,555	18,728	€ 2,063	2,063

(g) Details of key management personnel compensation for the years ended December 31, 2011 and 2010 are summarized as follows:

		In millions of won	
		2011	2010
Short-term employee benefits	₩	21,658	17,410
Post-employment benefits		2,227	1,242
	₩	23,885	18,652

# KT&G CORPORATION AND SUBSIDIARIES

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### 31. RISK MANAGEMENT

#### (a) Overview

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

- credit risk
- liquidity risk
- currency risk
- interest rate risk
- other market price risk.

This note presents information about the Group's exposure to each of the above risks, the Group's objectives, policies and processes for measuring and managing risk and the Group's management of financial 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 Group'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 Group's underlying operations. The treasury department monitors and manages the financial risk arising from the Group'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 the Risk Management Committee of the Group. 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 internal auditor consistently observes the compliance of the risk management policy and procedures, and reviews the risk exposure limit of the Group. The Group holds derivative financial instruments to hedge its specific financial risks such as currency risk.

#### Credit Risk

The Group 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 Group 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 Group's assets.

The carrying amount of financial assets is maximum exposure to credit risk. The maximum exposure to credit risk as of December 31, 2011 and 2010 is as follows:

		In millions of won	
		2011	2010
Available-for-sale financial assets	₩	248,403	315,177
Long-term deposits in MSA Escrow Fund		147,290	132,414
Trade and other receivables		967,425	740,949
Other financial assets		12,516	15,919
Cash and cash equivalents		807,731	981,314

#### (c) Management of Financial Risks

Export trade receivables to overseas clients, including Alokozay International Limited are ₩274,969 million and ₩235,636 million, and equal to 36.5% and 43.9% of the aggregate trade receivables, respectively, as of December 31, 2011 and 2010. The Group's trade receivables mentioned above were insured against non-payment up to USD 35,100 thousand and USD 38,525 thousand by export guarantee insurance with the Korea Export Insurance Corporation, respectively, as of December 31, 2011 and 2010. The Group has no significant concentration of customer credit risk since trade and other receivables, excluding the above export trade receivables, are widely dispersed amongst a number of customers.

The Group has made deposits on cash, cash equivalents and long-term deposits in NACF and several financial institutions with high credit ratings, thus the credit risks from these financial institutions are very limited.

#### Liquidity Risk

The Group has exposure to the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. The Group'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 Group's management determines whether or not the financial liabilities are repayable with the operating cash flows and cash inflows from financial assets. The Group entered into an overdraft agreement with the NACF to manage the temporary liquidity risk.

The maturity analysis with a residual contractual maturity of financial liabilities as of December 31, 2011 and 2010 is as follows:

		Carrying amount	Contractual cash flow	Residual contractual maturity			
				Within 3 months	Between 3 months and 1 year	Between 1 and 5 years	Beyond 5 years
<b>As of December 31, 2011:</b>							
Derivative financial liabilities	₩	-	-	-	-	-	-
Non-derivative financial liabilities:							
- Trade and other payables		311,421	312,555	95,050	208,109	7,338	2,058
- Short-term borrowings		82,836	82,998	50,354	32,644	-	-
- Long-term borrowings		37,847	45,568	175	542	44,550	301
- Current portion of long-term borrowings		3,126	3,166	1,243	1,923	-	-
	₩	435,230	444,287	146,822	243,218	51,888	2,359
<b>As of December 31, 2010:</b>							
Derivative financial liabilities	₩	-	-	-	-	-	-
Non-derivative financial liabilities:							
- Trade and other payables		197,299	197,913	90,119	94,746	13,048	-
- Short-term borrowings		66,507	67,432	45,384	22,048	-	-
- Long-term borrowings		1,540	1,747	15	44	1,380	308
- Current portion of long-term borrowings		506	515	132	383	-	-
	₩	265,852	267,607	135,650	117,221	14,428	308

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

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### (c) Management of Financial Risks, Continued

#### Currency Risk

The Group 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 Group's management has measured the currency risk internally and regularly, and has entered into foreign currency option contracts to hedge foreign currency risk in case of need.

The carrying amounts of monetary assets and liabilities denominated in a currency other than the functional currency as of December 31, 2011 and 2010 were as follows:

		In millions of won					
		2011			2010		
		USD	EUR	Other currency	USD	EUR	Other currency
<b>Assets:</b>							
Cash and cash equivalents	₩	26,121	68	1,471	11,461	1,340	477
Trade and other receivables		431,592	17,078	3,560	285,230	9,877	988
Long-term deposits							
in MSA Escrow Fund		147,290	-	-	132,414	-	-
	₩	605,003	17,146	5,031	429,105	11,217	1,465
<b>Liabilities:</b>							
Trade and other payables	₩	41,997	4,491	54,559	11,199	18,774	231
Short-term borrowings		-	-	-	77	-	-
	₩	41,997	4,491	54,559	11,276	18,774	231

As of December 31, 2011 and 2010, the effects of a 10% strengthening or weakening of functional currency against foreign currencies other than functional currency on profit before tax were as follows

		In millions of won			
		2011		2010	
		10% strengthening	10% weakening	10% strengthening	10% weakening
USD	₩	56,301	(56,301)	41,783	(41,783)
EUR		1,266	(1,266)	(756)	756
Other currency		(4,953)	4,953	123	(123)
	₩	52,614	(52,614)	41,150	(41,150)

The above sensitivity analysis was applied to monetary assets and liabilities denominated in foreign currencies other than the functional currency at the end of the reporting period.

#### Interest Rate Risk

The Group 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 Group'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 December 31, 2011 and 2010, the amount of borrowings issued at variable rates is ₩27,840 million and ₩24,045 million, respectively. There is no significant effect on cash flows or the fair value of financial liabilities from the interest rate fluctuation.

#### Other Market Price Risk

The Group has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Other market price risk arises from available-for-sale equity instruments held for investments. The Group's management has monitored the mix of debt and 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 Group's management.

As of December 31, 2011 and 2010, the effects of a 5% fluctuation of the price index of stocks on other comprehensive income were as follows:

		In millions of won			
		2011		2010	
		5% increase	5% decrease	5% increase	5% decrease
Other comprehensive income before tax	₩	8,464	(8,464)	13,338	(13,338)
Tax effect		(2,048)	2,048	(2,934)	2,934
	₩	6,416	(6,416)	10,404	(10,404)

### (d) Management of Capital Risk

The fundamental goal of capital management is the maximization of shareholders' value by means of stable dividend policy and the retirement of treasury shares. The capital structure of the Group consists of equity and net debt deducting cash and cash equivalents and current financial instruments from borrowings. The Group applied the same financial risk management strategy that was applied in the previous period.

As of December 31, 2011 and 2010, the Group defines net debt and equity attributable to owners of the Parent as follows:

		In millions of won	
		2011	2010
<b>Net debt:</b>			
Debt (borrowings)	₩	123,809	68,553
Less:			
- Cash and cash equivalents		(807,731)	(981,314)
- Current other financial assets		(11,089)	(15,273)
- Current available-for-sale financial assets		(1,044)	(1,000)
		(696,055)	(929,034)
<b>Equity attributable to owners of the Parent</b>	₩	<b>4,788,130</b>	<b>4,556,179</b>

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(e) Fair Value of Financial Instruments

The carrying amount and the fair value of financial instruments as of December 31, 2011 and 2010 are summarized as follows:

	In millions of won			
	2011		2010	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Assets:</b>				
<b>Financial assets measured at fair value</b>				
- Available-for-sale financial assets	₩ 241,924	241,924	284,849	284,849
- Long-term deposits in MSA Escrow Fund	147,290	147,290	132,414	132,414
- Other financial assets	12,516	12,516	15,919	15,919
	₩ 401,730	401,730	433,182	433,182
<b>Other financial assets</b>				
- Available-for-sale financial assets	₩ 6,479	-	30,328	-
<b>Financial assets measured at amortized cost</b>				
- Trade and other receivables	967,425	967,425	740,949	740,949
- Cash and cash equivalents	807,731	807,731	981,314	981,314
	₩ 1,775,156	1,775,156	1,722,263	1,722,263
	₩ 2,183,365	2,176,886	2,185,773	2,155,445
<b>Liabilities:</b>				
<b>Financial liabilities measured at fair value</b>				
	₩ -	-	-	-
<b>Financial liabilities measured at amortized cost</b>				
- Trade and other payables	₩ (311,421)	(311,421)	(197,299)	(197,299)
- Long-term borrowings	(37,847)	(37,847)	(1,540)	(1,540)
- Short-term borrowings	(82,836)	(82,836)	(66,507)	(66,507)
- Current portion of long-term borrowings	(3,126)	(3,126)	(506)	(506)
	₩ (435,230)	(435,230)	(265,852)	(265,852)
	₩ (435,230)	(435,230)	(265,852)	(265,852)

(e) Fair Value of Financial Instruments, Continued

*The Fair Value Hierarchy*

The Group classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The level of fair value hierarchy is as follows:

- Level I The quoted prices in active markets for identical assets or liabilities
- Level II The inputs that are observable for the asset or liability, either directly or indirectly
- Level III The inputs for the asset or liability that are not based on observable market data

The fair value measurements classified by fair value hierarchy as of December 31, 2011 and 2010 were as follows:

	In millions of won			
	Level I	Level II	Level III	Total
<b>As of December 31, 2011:</b>				
<b>Financial assets</b>				
- Available-for-sale financial assets	₩ 187,312	42,603	12,009	241,924
- Long-term deposits in MSA Escrow Fund	147,290	-	-	147,290
- Other financial assets	12,516	-	-	12,516
	₩ 347,118	42,603	12,009	401,730
<b>As of December 31, 2010:</b>				
<b>Financial assets</b>				
- Available-for-sale financial assets	₩ 252,055	20,062	12,732	284,849
- Long-term deposits in MSA Escrow Fund	132,414	-	-	132,414
- Other financial assets	15,919	-	-	15,919
	₩ 400,388	20,062	12,732	433,182

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### 32. CONTINGENT LIABILITIES AND FINANCIAL COMMITMENTS

- (a) Each year the Group 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 Group 25 years from the date of each annual funding. The Group 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 December 31, 2011, tobacco lawsuits claiming damages of ₩584 million are filed against the Group and the Korean government. The plaintiffs have asserted that the Group and the Korean government did not perform their obligations to notify smokers of the potential health hazards of smoking. Additionally, as of December 31, 2011, the Group is involved in ten lawsuits as a defendant for alleged damages totalling ₩8,689 million. The amount of the liability the Group may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of December 31, 2011.
- (c) As of December 31, 2011, the Group has entered into letter of credit agreements with Korea Exchange Bank and other banks with limits in the aggregate of USD 47,700 thousand.
- (d) As of December 31, 2011, the Group's trade receivables from the export of cigarettes are insured against non-payment up to USD 35,100 thousand by an export guarantee insurance with the Korea Export Insurance Corporation.
- (e) As of December 31, 2011, the Group has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries up to USD70,000 thousand by Korea Exchange Bank and others.
- (f) The Group has maintained a contract with the farmers who grow six-year old green ginseng for purchase volume guarantees and recorded contractual amounts paid to the farmers as advance payments in the amount of ₩189,189 million (non-current: ₩139,201 million, current: ₩49,988 million) and ₩170,518 million (non-current: ₩136,500 million, current: ₩34,018 million) as of December 31, 2011 and 2010, respectively.
- (g) As of December 31, 2011, the Group has entered into an account receivable loan agreement with a limit of ₩7,000 million with Hana Bank and other financial institutions.
- (h) As of December 31, 2011, the Group has entered into a trade bill loan agreement with a limit of ₩3,000 million with Korea Exchange Bank and other financial institutions.
- (i) As of December 31, 2011, the Group has entered into a loan agreement with a limit of ₩29,130 million with Shinhan Bank and other financial institutions.
- (j) As of December 31, 2011, the Group has provided two blank notes, 13 notes amounting to ₩14,200 million and five blank checks to Resolution and Finance Corporation and others as collateral for its borrowings and trade agreements. As of December 31, 2011, one lost note provided as collateral is in the process of nullification.
- (k) As of December 31, 2011, the Group and 28 other companies are guaranteed ₩240,000 million by Seoul Guarantee Insurance Co., Ltd. related to the Yongsan International Commercial Development Project.

(l) On March 17, 2011, the Group 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. Following this MOU, the Group entered into a joint investment agreement with Q Capital Partners Co., Ltd. which is a general partner of private equity fund as of November 11, 2011.

(m) With relation to the acquisition of Somang Cosmetics Co., Ltd., the Parent Company entered into a contract with a former owner of the acquiree, Kang, Seok-Chang ("Individual Shareholder"). Details of the contract are as follows:

Description	Details
Conditional put option granted to Individual Shareholder	The Parent Company shall be required to purchase Individual Shareholder's shares, in whole or in part, at the agreed price if the following conditions are met: <ul style="list-style-type: none"> <li>• Somang Cosmetics Co., Ltd. satisfies all the listing requirements.</li> <li>• Notwithstanding the written request of Individual Shareholder, Somang Cosmetics Co., Ltd. is not able to undertake the necessary procedures for listing, due to the Parent Company's objection, within three years after the Parent Company acquired Somang Cosmetics Co., Ltd.</li> </ul>
Right of first refusal held by the Parent 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 Parent Company.
Tag-along right held by Individual Shareholder	In the event that the Parent Company proposes to enter into a transaction or a series of related transactions with a third party purchaser to dispose of 50% or more 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 Parent Company.

(n) With relation to the acquisition of Mazence, Inc., the Parent 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 Mazence, Inc. is listed.
Right of first refusal held by the Parent 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 Parent Company.
Tag-along right held by Individual Shareholder	In the event that the Parent 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 Parent Company.

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

### 33. NON-CURRENT ASSETS HELD FOR SALE

In 2011, the Group entered into a contract to sell the land, buildings and others in Cheongju plant to Cheongju City for the purpose of business rationalization. The Group received ₩977 million out of the total present value of sale proceeds amounting to ₩31,255 million, with the remaining amount of ₩30,278 million scheduled to be recovered annually in instalments.

Also, the Group entered into a contract to sell the land, buildings and others of Jeonbuk headquarters to Inwoo AD Co., Ltd. and other in 2011.

The Group recognized non-current assets held for sale at the lower of its carrying amount and fair value less costs to sell. Changes in non-current assets held for sale for the year ended December 31, 2011 were as follows:

	In millions of won			
	Land	Buildings	Structures	Total
<b>Balance at January 1, 2011:</b>				
Cost	₩ -	-	-	-
Accumulated depreciation	-	-	-	-
Carrying amount	₩ -	-	-	-
<b>Changes:</b>				
Disposal	₩ (3,740)	(1,925)	(94)	(5,759)
Reclassification from property, plant and equipment	6,013	2,801	141	8,955
	₩ 2,273	876	47	3,196
<b>Balance at December 31, 2011:</b>				
Cost	₩ 2,273	1,429	197	3,899
Accumulated depreciation	-	(553)	(150)	(703)
Carrying amount	₩ 2,273	876	47	3,196

### 34. CASH FLOWS FROM OPERATING ACTIVITIES

Details of cash generated from operations for the years ended December 31, 2011 and 2010 were as follows:

	₩	In millions of won	
		2011	2010
<b>Profit for the years</b>	₩	816,929	1,030,789
<b>Adjustments for:</b>			
- Income tax expense		344,135	374,886
- Finance costs		8,221	4,469
- Finance income		(47,339)	(270,338)
- Depreciation		152,885	147,673
- Amortization		4,494	1,324
- Retirement and termination benefits		39,836	86,939
- Foreign currency translations loss		6,706	5,755
- Loss on the write-down of inventories		629	164
- Impairment loss on trade receivables		1,727	410
- Impairment loss on other receivables		166	63
- Loss on sale of property, plant and equipment		3,493	2,386
- Loss on sale of intangible assets		647	159
- Impairment loss on intangible assets		15,914	3,681
- Impairment loss on investment property		-	1,437
- Other expense		7,270	7,236
- Share of loss of associates		8	288
- Share of gain of associates		(1,325)	-
- Reversal of write-down of inventories		(55)	-
- Foreign currency translations gain		(17,966)	(1,717)
- Reversal of impairment loss on trade receivables		(169)	(216)
- Gain on sale of subsidiaries		(1,139)	-
- Gain on sale of equity accounted investments		-	(300)
- Gain on sale of property, plant and equipment		(45,852)	(101,886)
- Gain on sale of intangible assets		(7,016)	(24)
	₩	1,282,199	1,293,178
<b>Changes in working capital:</b>			
- Trade receivables		(170,314)	(30,108)
- Other receivables		35,622	(21,542)
- Advance payments		(25,893)	(3,599)
- Prepaid expenses		(2,603)	(2,143)
- Prepaid tobacco excise and other taxes		(21,179)	(7,603)
- Inventories		15,212	14,122
- Trade payables		(4,040)	1,386
- Other payables		44,800	(25,333)
- Advance receipts		6,410	(13,257)
- Tobacco excise and other taxes payable		(11,167)	(25,193)
- Payment of retirement and termination benefits		(37,399)	(81,201)
<b>Cash generated from operations</b>	₩	1,111,648	1,098,707

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

### 35. DIVIDENDS

Dividends and dividends per share proposed or declared before the consolidated financial statements were authorized for issue but not recognized as a distribution to owners during the years ended December 31, 2011 and 2010 are as follows:

	In millions of won, except share information and dividends per share	
	2011	2010
Number of shares receivable dividend	125,748,800	127,648,800
Dividends per share in won	₩ 3,200	3,000
<b>Total dividends</b>	<b>402,396</b>	<b>382,946</b>

### 36. DATE OF AUTHORIZATION FOR ISSUANCE

The consolidated financial statements were authorized for issuance on January 19, 2012, at the Board of Directors meeting.

### 37. BUSINESS COMBINATIONS AND DISPOSALS

(a) The Parent Company resolved to acquire the cosmetic segment of Somang Cosmetics Co., Ltd. at the Board of Directors meeting held on June 24, 2011. Accordingly, Somang Cosmetics Co., Ltd. spun off the non-cosmetic segment into a separate non-cosmetic company and the Parent Company obtained control of Somang Cosmetics Co., Ltd. by acquiring a 60.00% share of the surviving cosmetic company for ₩60,721 million as of September 1, 2011.

The goodwill of ₩32,131 million was recognized as a result of the acquisition as follows:

	In millions of won		
	Book value	Fair value adjustments	Fair value
Property, plant and equipment	₩ 6,887	-	6,887
Intangible assets	200	43,200	43,400
Inventories	15,636	-	15,636
Trade and other receivables	28,253	-	28,253
Other assets	4,423	-	4,423
Cash and cash equivalent	7,816	-	7,816
Deferred tax assets	2,743	-	2,743
Trade and other payables	(25,499)	-	(25,499)
Borrowings	(18,865)	-	(18,865)
Other liabilities	(3,585)	-	(3,585)
Defined benefit liabilities	(2,721)	-	(2,721)
Deferred tax liabilities	-	(9,504)	(9,504)
<b>Fair value of identifiable net assets</b>	<b>₩ 15,288</b>	<b>33,696</b>	<b>48,984</b>
Less: non-controlling interests of net assets acquired			(20,394)
<b>Fair value of identifiable net assets attributable to owners of the Parent Company</b>	<b>₩</b>		<b>28,590</b>
Goodwill			32,131
<b>Total consideration transferred</b>	<b>₩</b>		<b>60,721</b>

The book values of the identifiable assets acquired and the liabilities assumed have been remeasured to their acquisition-date fair values. The main adjustments relate to the recognition of customer relationships of ₩17,600 million, brand value of ₩25,600 million and the related deferred tax liabilities of ₩9,504 million, including non-controlling interests.

The goodwill of ₩32,131 million is attributable mainly to the anticipated synergies and economy of scale to be achieved from this business combination.

The Group recognized acquisition-related costs of ₩150 million related to external legal fees and due diligence costs as commissions in the consolidated statement of comprehensive income for the year ended December 31, 2011.

In the period from September 1, 2011 to December 31, 2011, the acquired business contributed revenue of ₩56,250 million and loss for the year of ₩1,216 million to the Group's results. If the acquisition had occurred on January 1, 2011, management estimates that consolidated revenue would have been ₩3,793,828 million and profit would have been ₩816,553 million for the year ended December 31, 2011.

# KT&G CORPORATION AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements

December 31, 2011 and 2010

(b) The Parent Company obtained control of Renzoluc Pte., Ltd., based in Singapore, which has a 51% share of the tobacco manufacturing company PT Trisakti Purworsari Makmur, based in Indonesia, by acquiring the entire share of the investee for ₩89,756 million as of October 7, 2011.

The goodwill of ₩53,341 million was recognized as a result of the acquisition as follows:

		In millions of won		
		Book value	Fair value adjustments	Fair value
Property, plant and equipment	₩	16,391	7,373	23,764
Intangible assets		2,052	49,635	51,687
Inventories		74,552	11,924	86,476
Trade and other receivables		12,628	11,168	23,796
Other assets		9,752	-	9,752
Cash and cash equivalent		21,867	-	21,867
Deferred tax assets		481	-	481
Trade and other payables		(34,776)	-	(34,776)
Borrowings		(79,601)	-	(79,601)
Other liabilities		(1,426)	(21,899)	(23,325)
Defined benefit liabilities		(2,530)	-	(2,530)
Deferred tax liabilities		-	(16,681)	(16,681)
<b>Fair value of identifiable net assets</b>	<b>₩</b>	<b>19,390</b>	<b>41,520</b>	<b>60,910</b>
Less: non-controlling interests of net assets acquired				(24,495)
<b>Fair value of identifiable net assets attributable to owners of the Parent Company</b>	<b>₩</b>			<b>36,415</b>
Goodwill				53,341
<b>Total consideration transferred</b>	<b>₩</b>			<b>89,756</b>

The book values of the identifiable assets acquired and the liabilities assumed have been remeasured to their acquisition-date fair values. The main adjustments relate to the recognition of customer relationships of ₩8,122 million, brand value of ₩31,368 million and the related deferred tax liabilities of ₩9,556 million, including non-controlling interests.

The goodwill of ₩53,341 million is attributable mainly to the anticipated synergies and economy of scale to be achieved from this business combination.

The Group recognized acquisition-related costs of ₩877 million related to external legal fees and due diligence costs as commissions in the consolidated statement of comprehensive income for the year ended December 31, 2011.

The Group consolidated Renzoluc Pte., Ltd. with effect from December 31, 2011, provided that the effect thereof is immaterial to the consolidated financial statements.

(c) The Parent Company obtained control of Mazence, Inc. by acquiring a 59.48% of the investee for ₩31,232 million as of December 22, 2011.

The goodwill of ₩2,430 million was recognized as a result of the acquisition as follows:

		In millions of won		
		Book value	Fair value adjustments	Fair value
Property, plant and equipment	₩	1,022	-	1,022
Intangible assets		20,755	12,728	33,483
Inventories		17	-	17
Trade and other receivables		128	-	128
Other assets		2,192	-	2,192
Cash and cash equivalent		20,080	-	20,080
Trade and other payables		(338)	-	(338)
Borrowings		(13,795)	-	(13,795)
Other liabilities		(318)	-	(318)
Defined benefit liabilities		(437)	-	(437)
Deferred tax liabilities		-	(3,080)	(3,080)
<b>Fair value of identifiable net assets</b>	<b>₩</b>	<b>29,306</b>	<b>9,648</b>	<b>38,954</b>
Less: non-controlling interests of net assets acquired				(10,152)
<b>Fair value of identifiable net assets attributable to owners of the Parent Company</b>	<b>₩</b>			<b>28,802</b>
Goodwill				2,430
<b>Total consideration transferred</b>	<b>₩</b>			<b>31,232</b>

The book values of the identifiable assets acquired and the liabilities assumed have been remeasured to their acquisition-date fair values. The main adjustments relate to the recognition of intangible assets under development of ₩12,728 million and the related deferred tax liabilities of ₩3,080 million, including non-controlling interests.

The goodwill of ₩2,430 million is attributable mainly to the anticipated synergies and economy of scale to be achieved from this business combination.

The Group recognized acquisition-related costs of ₩65 million related to external legal fees and due diligence costs as commissions in the consolidated statement of comprehensive income for the year ended December 31, 2011.

The Group consolidated Mazence, Inc. with effect from December 31, 2011, provided that the effect thereof is immaterial to the consolidated financial statements.

(d) Korea Ginseng HK, Ltd. and Purpleland Development Co., Ltd., both of which were subsidiaries of the Parent Company, were liquidated in 2011. With relation to those liquidations, the Group recognized ₩1,139 million of gain on sale of subsidiaries in the consolidated statement of comprehensive income for the year ended December 31, 2011.

Seeds of Imagination  
Turn into **KT&G**



## Corporate Governance



**President & CEO**

Min, Young Jin

### | Independent Non-executive Directors |



**Kim, Won Yong**  
Chairman of BOD



**Kim, Duk Hwi**



**Jee, Seung Lim**



**Cho, Kyu Ha**



**Lee, Wang Jae**



**Kim, Jung Sik**



**Chung, Young Kee**

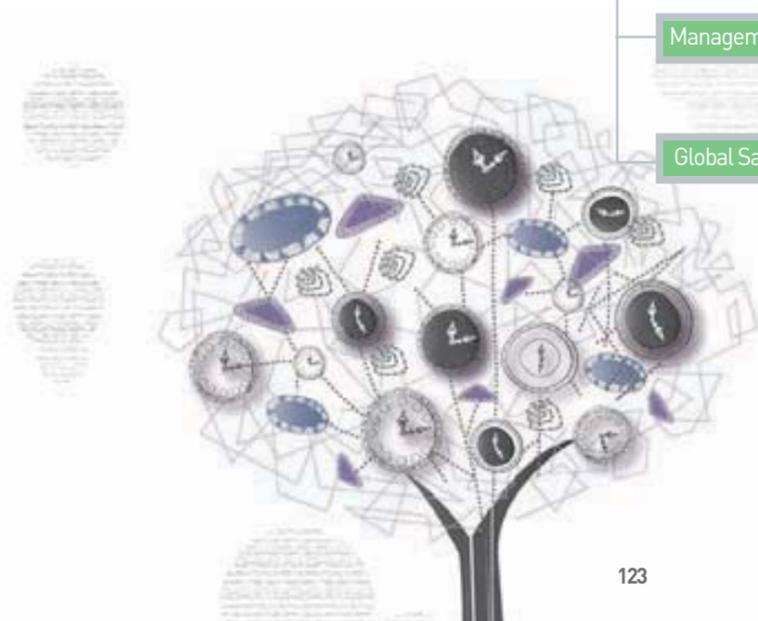
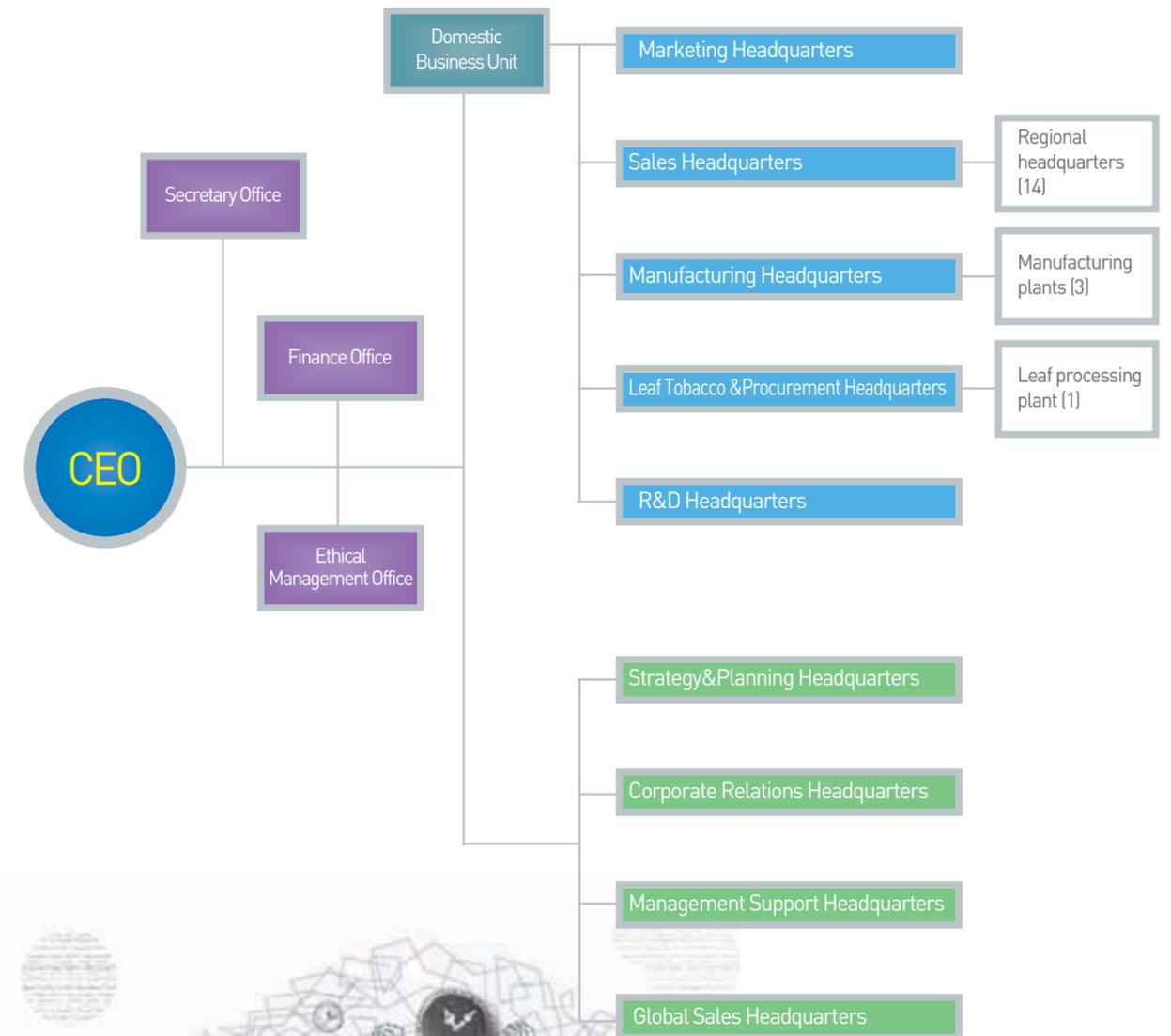


**Kim, In Ho**



**Son, Won Ik**

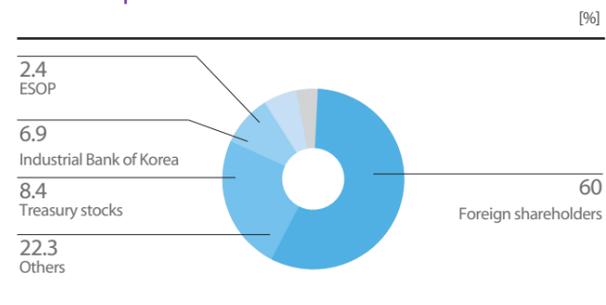
## Organizational Structure



## Overseas Subsidiaries & Branches



### Ownership Structure



• Capital Stock	KRW 955 billion
• Number of Authorized Shares	800,000,000
• Number of Shares Issued	137,292,497
• Shareholders' Equity	KRW 4,544 billion



### INQUIRIES

- INVESTOR RELATIONS DEPARTMENT  
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 - www.ktng.com