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Consolidated Five-Year Financial Summary

Japan Tobacco Inc. and Consolidated Subsidiaries
Years ended March 31

	Millions of yen					Millions of U.S. dollars
	2003	2004	2005	2006	2007	2007
For the year:						
Net sales	¥ 4,492,264	¥ 4,625,151	¥ 4,664,514	¥ 4,637,657	¥ 4,769,387	$ 40,401
EBITDA (Note 2)	337,296	373,435	400,115	433,391	464,634	3,936
Depreciation and amortization (Note 2)	148,333	139,401	126,744	126,445	132,643	1,123
Operating income	188,963	234,034	273,371	306,946	331,991	2,812
Net income (loss)	75,302	(7,603)	62,584	201,542	210,772	1,785
For the year:						
Net cash provided by operating activities	¥ 258,057	¥ 334,501	¥ 250,840	¥ 150,343	¥ 435,958	$ 3,693
Net cash provided by (used in) investing activities	(74,877)	(228,620)	176,914	(26,358)	(149,692)	(1,268)
Net cash used in financing activities	(111,968)	(109,335)	(202,196)	(48,135)	(32,635)	(277)
Free cash flow (Note 3)	170,372	269,174	269,459	145,590	223,007	1,889
At year-end:						
Net property, plant and equipment	¥ 733,314	¥ 708,221	¥ 639,655	¥ 596,544	¥ 600,436	$ 5,086
Total assets	2,957,665	3,029,084	2,982,056	3,037,379	3,364,663	28,502
Interest bearing debt	424,499	381,203	230,716	216,608	219,269	1,858
Liabilities	1,283,939	1,467,322	1,430,256	1,217,306	1,340,047	11,352
Total equity	1,622,654	1,507,937	1,498,204	1,762,512	2,024,616	17,150
Profitability:						
Return on equity	4.7%	(0.5%)	4.2%	12.4%	11.3%	—
EBITDA margin	7.5%	8.1%	8.6%	9.3%	9.7%	—
Operating income margin	4.2%	5.1%	5.9%	6.6%	7.0%	—
Total assets turnover	1.49	1.55	1.55	1.54	1.49	—
Stability:						
Equity ratio	54.9%	49.8%	50.2%	58.0%	58.3%	—
Debt/Equity ratio (times)	0.26	0.25	0.15	0.12	0.11	—
Current ratio	226.4%	195.3%	202.7%	256.7%	226.4%	—
Fixed assets/Long-term capital ratio	69.7%	69.9%	67.6%	60.7%	61.3%	—

Notes: 1. Figures stated in U.S. dollars in this report are translated solely for convenience at the rate of ¥118.05 per $1, the rate of exchange as of March 31, 2007.
2. EBITDA = operating income + depreciation and amortization
Depreciation and amortization = depreciation of tangible fixed assets + amortization of intangible fixed assets + amortization of long-term prepaid expenses + amortization of goodwill
3. FCF = (cash flow from operating activities + cash flow from investing activities) excluding the following items:
From “cash flow from operating activities”: Dividends received / interest received and its tax effect / interest paid and its tax effect
From “cash flow from investing activities”: Cash outflow from purchase of marketable securities / proceeds from sales of marketable securities / cash outflow from purchases of investment securities / proceeds from sales of investment securities / others (but not business-related investment securities, which are included in the investment securities item)

Segment Information

	Millions of yen					Millions of U.S. dollars
	2003	2004	2005	2006	2007	2007
Net sales	¥ 4,492,264	¥ 4,625,151	¥ 4,664,514	¥ 4,637,657	¥ 4,769,387	$ 40,401
Tobacco	4,134,466	4,236,920				
Domestic			3,491,488	3,405,281	3,416,274	28,939
International			792,705	881,188	999,658	8,468
Pharmaceutical	53,927	51,242	57,676	49,257	45,452	385
Foods	232,404	250,138	265,380	278,378	286,554	2,427
Others	71,467	86,851	57,265	23,553	21,449	182
EBITDA	¥ 337,296	¥ 373,435	¥ 400,115	¥ 433,391	¥ 464,634	$ 3,936
Tobacco	321,419	343,163				
Domestic			296,031	305,753	326,470	2,765
International			65,462	94,093	112,668	954
Pharmaceutical	(5,110)	(4,426)	5,474	(1,803)	(8,197)	(69)
Foods	546	3,300	7,931	11,869	12,018	102
Others	19,674	30,674	26,810	22,140	21,586	183
Elimination/Corporate	767	724	(1,593)	1,339	89	1
Operating income	¥ 188,963	¥ 234,034	¥ 273,371	¥ 306,946	¥ 331,991	$ 2,812
Tobacco	213,342	238,409				
Domestic			215,833	220,095	245,388	2,078
International			44,458	71,031	81,085	687
Pharmaceutical	(13,855)	(12,840)	1,855	(5,057)	(11,207)	(95)
Foods	(13,168)	(4,851)	1,948	6,325	6,705	57
Others	932	11,976	10,427	8,673	9,331	79
Elimination/Corporate	1,712	1,340	(1,150)	5,879	689	6

Four business segments, namely Tobacco, Pharmaceutical, Foods and Others, had been used for the consolidated financial statements up to the year ended March 31, 2005. From the year ended March 31, 2006, the tobacco segment is divided into Domestic tobacco and International tobacco in order for our business results to be more properly shown, considering the importance of the Group's tobacco business in which JT International S.A., a foreign consolidated subsidiary, conducts the main operational role. As a result, five business segments, namely Domestic tobacco, International tobacco, Pharmaceutical, Foods and Others, are used for the consolidated financial statements. As for the results of the year ended March 31, 2005, retroactive application was made in accordance with the new business segments as well.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements prepared in accordance with accounting principles generally accepted in Japan and other information included in other sections of this annual report. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Actual results may differ materially from those anticipated in these statements as a result of a number of factors, including, but not limited to, those described in the "Major Risks of Businesses" (See p.41 for more details).

Overview

We operate primarily in the domestic and international tobacco businesses, the pharmaceutical business and the foods business. In our domestic and international tobacco businesses, we develop, manufacture, distribute, and sell tobacco products, primarily cigarettes. In our pharmaceutical business, we develop, manufacture and sell pharmaceutical products. In our foods business, we develop, manufacture and sell processed foods, and develop and sell beverages. Our other business segment includes our commercial real estate and other operations.

Our net sales were ¥4,637.7 billion for the year ended March 31, 2006 and ¥4,769.4 billion for the year ended March 31, 2007. Domestic and international tobacco businesses accounted for 73.4% and 19.0% of our net sales for the year ended March 31, 2006 and 71.6% and 21.0% of our net sales for the year ended March 31, 2007, respectively. In recent years, net sales in our international tobacco business have become an increasingly important component of our total net sales. In recent periods, net sales have also increased in our foods business while decreasing in our pharmaceutical business.

Our operating income was ¥306.9 billion for the year ended March 31, 2006 and ¥332.0 billion for the year ended March 31, 2007. Although the foods business segment has recorded operating income since the year ended March 31, 2005, our pharmaceutical business has recorded operating losses every year since the year ended March 31, 1998, when we started to disclose industry segment information, except for the year ended March 31, 2005. As a result, substantially all of our operating income is derived from our tobacco business.

Acquiring Outside Resources

We significantly increased our international tobacco sales through the $7.8 billion acquisition of the non-U.S. tobacco operations of RJR Nabisco, Inc. in May 1999. The purpose of this acquisition was to enhance and diversify our profit sources and cash flows. This acquisition expanded our ability to sell tobacco products in the international markets and provided us with the rights to internationally recognized trademarks such as Camel, Winston and Salem in substantially all countries outside of the United States. These three brands, together with Mild Seven, constitute our global flagship brands, or GFB. The integration of RJR's non-U.S. tobacco operations and our international tobacco operations was completed in 2000. Since this acquisition, our international tobacco business sales, in particular overseas sales of our GFB, have increased steadily. We will continue to focus on boosting overseas sales of GFB to improve our profitability and make GFB stronger sources of profits and cash flows.

We completed the acquisition procedure to make Gallaher Group Plc a wholly owned subsidiary of JT on April 18, 2007. The acquisition price was approx. £7.50 billion (approx. ¥1,720 billion), and the total acquisition price including the assumption of net interest-bearing debt was approx. £9.44 billion (approx. ¥2,180 billion). Of the approx. ¥1,720 billion amount, approx. ¥820 billion was covered by our cash on hand, ¥450 billion by a loan from Mizuho Bank, Ltd, and £1.9 billion (¥450 billion) by a syndicate loan arranged by Merrill Lynch.

With the acquisition of Gallaher, we have further strengthened our position as the world's third largest tobacco company. In addition to our strong business foundation in Asia, JT now has an increasing presence in Europe and the CIS region. We aim at even more sustainable growth as a leading company of the tobacco industry characterized by a good geographical balance and ample opportunities for growth.

As a result of this acquisition, we expect a number of integration effects such as scale expansion, mutually complementary operations, and a reinforcement of our technology and distribution infrastructure. In addition, we believe we can generate enormous synergy effects by integrating the businesses of both groups, which will allow us to increase our top line results and to cut costs through improved business efficiency. We will make efforts to establish a group system that will allow prompt and maximum realization of the synergy effects that can be obtained through the integration of our businesses.

In order to further diversify our future sources of profits and cash flows, we have been developing our pharmaceutical and foods businesses. Our acquisition of 53.5% of the outstanding shares of Torii Pharmaceutical Co., Ltd. in December 1998 significantly increased the scale of our pharmaceutical business. We greatly expanded our foods business through the acquisition in 1998 of a majority stake in Unimat Corporation, later renamed Japan Beverage Inc., a Japanese vending machine operator with a large network of vending machines nationwide, and through the acquisition of the processed foods operations of Asahi Kasei Corporation in July 1999. We have been developing these operations and refining their focus through selective investments, acquisitions, joint ventures and licensing arrangements. We are striving to transform these businesses into steady future sources of profits and cash flows.

Results by Industry Segment

Table of Results by Industry Segment

For years ended March 31	Millions of yen 2005	2006	2007	Millions of U.S. dollars 2007
Net sales	¥ 4,664,514	¥ 4,637,657	¥ 4,769,387	$ 40,401
Tobacco Business				
Domestic	3,491,488	3,405,281	3,416,274	28,939
International	792,705	881,188	999,658	8,468
Pharmaceutical Business	57,676	49,257	45,452	385
Foods Business	265,380	278,378	286,554	2,427
Other Business	57,265	23,553	21,449	182

	Millions of yen 2005	2006	2007	Millions of U.S. dollars 2007
Operating income	¥ 273,371	¥ 306,946	¥ 331,991	$ 2,812
Tobacco Business				
Domestic	215,833	220,095	245,388	2,078
International	44,458	71,031	81,085	687
Pharmaceutical Business	1,855	(5,057)	(11,207)	(95)
Foods Business	1,948	6,325	6,705	57
Other Business	10,427	8,673	9,331	79
Elimination/Corporate	(1,150)	5,879	689	6

Domestic tobacco: Net sales for the domestic tobacco business were ¥3,405.3 billion for the year ended March 31, 2006 and ¥3,416.3 billion for the year ended March 31, 2007. The sales of products that we manufactured in Japan included Marlboro which we manufactured under a license agreement with Altria. The license agreement expired in April 2005 and both sides agreed not to renew. Our domestic tobacco business also includes sales in Japan of tobacco products of other foreign tobacco manufacturers. We derive significantly lower profit margins from the sale of these imported tobacco products than from the rest of our domestic tobacco business as our function is limited to distribution.

International tobacco: Net sales for the international tobacco business were ¥881.2 billion for the year ended March 31, 2006 and ¥999.7 billion for the year ended March 31, 2007. International tobacco sales include overseas sales of products manufactured by our overseas subsidiaries and sales of tobacco products manufactured in Japan and exported to foreign countries.

Pharmaceutical: The pharmaceutical business accounted for approximately 1.1% of our net sales for the year ended March 31, 2006 and 1.0% of our net sales for the year ended March 31, 2007. The pharmaceutical business recorded an operating income of ¥1.9 billion for the year ended March 31, 2005. This was due to one-time revenue from the licensing-out of a chemical compound. The business recorded operating losses of ¥5.1 billion for the year ended March 31, 2006 and ¥11.2 billion for the year ended March 31, 2007. We do not expect our pharmaceutical business to generate profits in the next few years.

Foods: The foods business accounted for approximately 6.0% of our net sales for the year ended March 31, 2006 and 6.0% of our net sales for the year ended March 31, 2007. The operating income recorded for the foods business was ¥6.3 billion for the year ended March 31, 2006 and ¥6.7 billion for the year ended March 31, 2007.

Other: Other business segment accounted for approximately 0.5% of our net sales for the year ended March 31, 2006 and 0.4% of our net sales for the year ended March 31, 2007. Net sales from other business segment on the whole have been gradually decreasing in recent years. Operating income for other business segment was ¥8.7 billion for the year ended March 31, 2006 and ¥9.3 billion for the year ended March 31, 2007. Currently we do not plan to expand this segment and thus we expect net sales from this segment to decrease gradually, as we re-evaluate businesses in this segment.

Results by Geographic Segment

We divide our operations into three geographic segments based on the location of the entity recording the sales: Japan, Western Europe (including Switzerland, France and Germany) and other regions. The other regions segment comprises primarily Asia (excluding Japan but including China, Hong Kong and Macau), Canada, Russia and the other Commonwealth of Independent States nations, the Middle East and Africa.

Table of Results by Geographic Segment

	Millions of yen			Millions of U.S. dollars
For years ended March 31	2005	2006	2007	2007
Net sales	¥ 4,664,514	¥ 4,637,657	¥ 4,769,387	$ 40,401
Japan	3,823,102	3,709,964	3,718,450	31,499
Western Europe	317,273	338,606	353,831	2,997
Other	524,139	589,087	697,106	5,905

	Millions of yen			Millions of U.S. dollars
	2005	2006	2007	2007
Operating income	¥ 273,371	¥ 306,946	¥ 331,991	$ 2,812
Japan	228,347	228,137	248,482	2,105
Western Europe	(3,373)	(847)	(18,810)	(159)
Other	48,696	72,865	101,552	860
Elimination/Corporate	(299)	6,791	767	6

Japan: Net sales in Japan for the year ended March 31, 2007 increased by ¥8.5 billion, or 0.2%, to ¥3,718.5 billion in comparison with the previous fiscal year. Despite a sales volume decrease in our domestic tobacco business, revenue increased in line with unit sales price increases based on the revision of retail prices. Operating income for the year ended March 31, 2007 increased by ¥20.3 billion, or 8.9%, to ¥248.5 billion in comparison with the previous fiscal year. This was primarily due to the above mentioned unit sales price rise and cost reductions.

Net sales in Japan for the year ended March 31, 2006 decreased by ¥113.1 billion, or 3.0%, to ¥3,710.0 billion from the previous fiscal year. This decrease was primarily due to a sales decrease in our domestic tobacco business. Despite a decrease in operating expenses as a result of cost reduction efforts, operating income for the year ended March 31, 2006 decreased by ¥0.2 billion, or 0.1%, to ¥228.1 billion from the previous fiscal year.

Western Europe: Net sales in Western Europe for the year ended March 31, 2007 increased by ¥15.2 billion, or 4.5%, to ¥353.8 billion from the previous fiscal year. This was primarily due to the impact of favorable exchange rates in converting foreign currencies into Japanese yen, which offset the negative impact derived from a hike in the tobacco excise tax in Spain. Operating loss for the year ended March 31, 2007 deteriorated by ¥18.0 billion from the previous fiscal year to ¥18.8 billion. This was primarily due to negative impacts derived from Spain's tobacco tax hike, as well as the transfer of sales in Japan from the international tobacco business to the domestic tobacco business from May 2005.

Net sales in Western Europe for the year ended March 31, 2006 increased by ¥21.3 billion, or 6.7%, to ¥338.6 billion from the previous fiscal year. This was primarily due to a sales increase in Italy. Operating loss for the year ended March 31, 2006 improved by ¥2.5 billion from the previous fiscal year to a ¥0.8 billion loss.

Other Regions: Net sales in other regions for the year ended March 31, 2007 increased by ¥108.0 billion, or 18.3%, to ¥697.1 billion from the previous fiscal year. This was primarily due to an increase in international tobacco sales by JT International, particularly in countries such as Russia, Iran, Turkey, and Ukraine. Operating income for the year ended March 31, 2007 increased by ¥28.7 billion, or 39.4%, to ¥101.6 billion from the previous fiscal year.

Net sales in other regions for the year ended March 31, 2006 increased by ¥64.9 billion, or 12.4%, to ¥589.1 billion from the previous fiscal year. This was primarily due to an increase in international tobacco sales by JT International, particularly in countries such as Russia, Iran, Ukraine and Taiwan. Operating income for the year ended March 31, 2006 increased by ¥24.2 billion, or 49.6% to ¥72.9 billion from the previous fiscal year.

Outlook of Results for the Year Ending March 31, 2008

It is too early to forecast results of operations for the fiscal year ending March 31, 2008. However, based on current trends and other factors we know at this point, we expect a revenue increase and a profit decrease in our business performance, excluding the impacts arising from the purchase of Gallaher. We believe that net sales in the international tobacco business will increase due to well-balanced growth in sales volume in both mature and emerging markets. However, we believe this increase will be partially offset by a

decrease in the sales volume of the domestic tobacco business.

Although we expect operating income to decrease mainly due to a sales volume decrease in the domestic tobacco business, we expect this decline will be partially offset by top-line growth in the international tobacco business stemming from focusing on GFBs and enhancing our brand portfolio.

We expect net income to decrease for the period. The main factors for this are increase in interest expenses related to the Gallaher acquisition, a decrease in interest revenue due to lower cash reserves, a decrease in net gains on the sale and disposal of fixed assets, and an increase in costs related to the introduction of vending machines with adult identification functions.

As we are still developing the Gallaher integration plan, these forecasts do not reflect the impact the acquisition will have, except for costs related to financing the acquisition.

Our actual operating results may vary significantly from those described above as a result of a number of factors including, but not limited to, those discussed in the "Major Risks of Businesses".

Results of Operations

Income Statement Data

	Millions of yen			Millions of U.S. dollars
For years ended March 31	2005	2006	2007	2007
Net sales	¥ 4,664,514	¥ 4,637,657	¥ 4,769,387	$ 40,401
Cost of sales	3,713,725	3,734,074	3,844,768	32,569
Gross profit	950,789	903,583	924,619	7,832
Selling, general and administrative expenses	677,418	596,637	592,628	5,020
Operating income	273,371	306,946	331,991	2,812
Other income (expenses), net	(172,038)	(5,953)	5,205	44
Income before income taxes and minority interest	101,333	300,993	337,196	2,856
Income taxes	31,565	94,896	121,405	1,028
Income before minority interest	69,768	206,097	215,791	1,828
Minority interest	7,184	4,555	5,019	43
Net income	¥ 62,584	¥ 201,542	¥ 210,772	$ 1,785

Year Ended March 31, 2007 Compared to Year Ended March 31, 2006

Net sales

Net sales for the year ended March 31, 2007 increased by ¥131.7 billion, or 2.8%, to ¥4,769.4 billion. Net sales described below represent amounts after the elimination of intersegment transactions.

• Domestic tobacco business

Net sales for the domestic tobacco business are comprised of domestic sales (including duty-free sales) of tobacco products manufactured by the group in or outside Japan and of products manufactured by foreign tobacco manufacturers and distributed by our subsidiaries as wholesalers, and sales in the China, Hong Kong and Macau markets, which are generated by JT's China Division. The group's net sales for the domestic tobacco business were ¥3,416.3 billion, an increase of ¥11.0 billion or 0.3% in net sales from the previous fiscal year. The sales volume of JT's tobacco products in Japan decreased by 14.5 billion cigarettes, or 7.7%, to 174.9 billion cigarettes from the previous fiscal year (see note). Sales volume declined despite the positive effect of the increased sales volume of JTI products such as Camel, Winston, and Salem sold in Japan since May 2005. The decline was mainly due to the continued decline in the total demand for cigarettes caused by the following factors: aging Japanese population, growing consciousness of smoking and health, tightened smoking regulations, revision of retail prices based on a hike in tobacco excise tax imposed in July 2006, and termination of the domestic manufacturing license for Marlboro products at the end of April 2005. Our market share declined by 1.6 percentage points to 64.8% in comparison with the previous fiscal year. Net sales (excluding excise tax) per 1,000 cigarettes increased by ¥126, or 3.3%, to ¥3,990 from the previous fiscal year, mainly due to a hike in unit sales prices caused by the revision of retail prices.

The sales volume of our tobacco products in Japan, excluding Marlboro products and including Camel, Winston, and Salem (on a like-for-like basis for comparability), decreased by 11.9 billion cigarettes, or 6.4%, from the previous fiscal year, while our market share declined by 0.7 percent compared to the previous fiscal year, with the net sales per 1,000 cigarettes increasing by ¥141, or 3.7%.

Note: In addition, domestic sales volume includes 3.4 billion cigarettes sold in domestic duty-free markets and in China, Hong Kong and Macau markets by our China Division.

• International tobacco business

Net sales of the international tobacco business were ¥999.7 billion, an increase of ¥118.5 billion or 13.4% from the previous fiscal year. The sales volume of our international tobacco business increased by 19.8 billion cigarettes, or 9.0%, to 240.1 billion cigarettes. Sales volume of GFB increased by 15.3 billion cigarettes, or 11.4%, to 149.1 billion cigarettes. Such increase was attributable to favorable sales of Camel in Italy and France, of Winston in Russia, Spain, Iran, Turkey and Ukraine, and of Mild Seven in Russia. The sales volume and GFB sales volume of our international tobacco business excluding the Japanese market (on a like-for-like basis for comparability) increased by 22.7 billion cigarettes, or 10.4%, and 17.9 billion cigarettes, or 13.6%, respectively, from the previous fiscal year. Sales denominated in foreign currencies are initially translated into U.S. dollars, and then translated into Japanese yen

using the 12-month average exchange rate. Net sales in U.S. dollars increased due to a sales volume increase mainly led by the GFB, offsetting negative impacts of a change in the method of revenue recognition and price competition in the Spanish market. Net sales in Japanese yen increased due to the depreciation of the Japanese yen against the U.S. dollar. The average exchange rates between the Japanese yen and U.S. dollar used for the translation were ¥110.26 to $1.00 for the year ended March 31, 2006 and ¥116.38 to $1.00 for the year ended March 31, 2007.

• Pharmaceutical business

Net sales in the pharmaceutical business decreased by ¥3.8 billion, or 7.7%, to ¥45.5 billion for the year ended March 31, 2007 from the previous fiscal year. We recorded one-time income from the licensing of a new chemical compound that is still at the pre-clinical trial stage to GlaxoSmithKline, and an antibody drug candidate at the pre-clinical trial stage to MedImmune. Nevertheless, net sales decreased primarily due to a decrease in royalty revenue from the anti-HIV viral drug Viracept amid intensifying competition and also to the net sales decline in our subsidiary Torii Pharmaceutical Co., Ltd. (hereinafter "Torii"). Net sales also fell due to the one-time income recorded in the previous fiscal year from the licensing of JTK-303 (anti-HIV) to US-based Gilead Sciences.

• Foods business

Net sales in the foods business increased by ¥8.2 billion, or 2.9%, to ¥286.6 billion from the previous fiscal year. Net sales in the beverage business increased by ¥5.5 billion, or 2.9%, to ¥190.8 billion, mainly due to steady expansion of the beverage vending machine sales channel and increased sales of the Roots brand of canned coffees. Net sales in the processed foods business increased by ¥2.7 billion, or 2.9 %, to ¥95.8 billion as a result of business expansion in the frozen processed foods and chilled processed foods business.

• Others

Net sales in other businesses decreased by ¥2.1 billion, or 8.9%, to ¥21.4 billion, primarily due to a decrease in the number of consolidated subsidiaries as a result of the transfer of their shares to other parties.

Cost of sales

For the year ended March 31, 2007, cost of sales increased by ¥110.7 billion, or 3.0%, to ¥3,844.8 billion from the previous fiscal year, principally as a result of the hike in the tobacco excise tax imposed in July 2006, the sales volume increase in our international tobacco business, and the business expansion in the foods business. This increase was partially offset by a decrease in the sales volume of our domestic tobacco business, an improvement of devaluation gains and losses on the leaf tobacco due to an increase in the use of domestic-grown tobacco, and a positive impact of the reduction in manpower resulting from a voluntarily early retirement program introduced in the previous fiscal year.

Selling, general and administrative expenses

For the year ended March 31, 2007, selling, general and administrative expenses decreased by ¥4.0 billion, or 0.7%, to ¥592.6 billion from the previous fiscal year. This decrease was primarily due to the following factors: a reduction in manpower resulting from the voluntarily early retirement program introduced in the previous fiscal year, a decrease in sales promotion costs due to a change in the method of revenue recognition in the international tobacco business, and a decrease in royalty payments as a result of the termination of the domestic manufacturing license for Marlboro products at the end of April 2005. However, the decrease was partially offset by a rise in research and development (R&D) costs for the pharmaceutical business and an increase in amortization expenses due to a change in the amortization periods applied to a part of the trademarks held by our international tobacco business.

Operating income

As a result of the above factors, operating income increased by ¥25.0 billion, or 8.2%, to ¥332.0 billion for the year ended on March 31, 2007. Operating income by business segment was as follows:

• Domestic tobacco business

Operating income in the domestic tobacco business for the year ended March 31, 2007 increased by ¥25.3 billion, or 11.5%, to ¥245.4 billion from the previous fiscal year. The increase is mainly attributed to the following factors: a rise in unit sales prices due to the revision of retail prices based on a hike in the tobacco tax imposed in July 2006, a reduction in manpower resulting from the voluntarily early retirement program introduced in the previous fiscal year, and an improvement of devaluation gains and losses on leaf tobacco due to an increase in use of domestic-grown tobacco. The increase, however, was partially offset by the decrease in sales volume.

• International tobacco business

Operating income in the international tobacco business for the year ended March 31, 2007 increased by ¥10.1 billion, or 14.2%, to ¥81.1 billion from the previous fiscal year. This was primarily due to favorable sales of the GFB, of which we are targeting intensively for profit growth. However, the increase was partially offset by the impact of the transfer of JTI's Japan business to the domestic tobacco business in May 2005, the price competition in the Spanish market, an investment to boost our production capacity, and an increase in amortization expenses due to a change in the amortization periods applied to a part of the trademarks we hold. Also, the decline in the exchange rate of the Japanese yen against the U.S. dollar contributed to the increase in profit.

• Pharmaceutical business

Operating income in the pharmaceutical business decreased by ¥6.1 billion from the previous year, resulting in an operating loss of ¥11.2 for the year ended March 31, 2007. This was primarily due to a decrease in net sales and an increase in R&D expenses due to the progress of our R&D activities.

• Foods business

For the year ended March 31, 2007, operating income increased by ¥0.4 billion, or 6.0%, to ¥6.7 billion from the previous fiscal year. This was primarily due to an improvement in margins resulting from business expansion. The increase, however, was partially offset by rising fixed costs such as salaries.

• Others

For the year ended March 31, 2007, operating income increased by ¥0.7 billion, or 7.6%, to ¥9.3 billion from the previous fiscal year. The increase was primarily due to a rise in real estate rental revenues. The increase, however, was partially offset by a decline in the number of consolidated subsidiaries as a result of the transfer of their shares to other parties.

Other income (expenses), net

Other expenses, net, decreased by ¥11.2 billion for the year ended March 31, 2007, resulting in net income of ¥5.2 billion. This was attributable to factors including an increase in net gains on the sales and disposal of fixed assets, a decrease in impairment losses, and a decrease in business restructuring costs, offsetting the impacts of currency hedging expenses and bridge loan related costs incurred for the purchase of Gallaher and costs incurred in the introduction of vending machines with adult identification functions.

Income before income taxes and minority interests

As a result of the above factors, income before income taxes and minority interests for the year ended March 31, 2007 increased by ¥36.2 billion, or 12.0%, to ¥337.2 billion from the previous fiscal year.

Income taxes

Income taxes for the year ended March 31, 2007 increased by ¥26.5 billion, or 27.9%, to ¥121.4 billion from the previous fiscal year. For the year ended March 31, 2007, the actual effective tax rate increased by 4.5 percentage points to 36.0%. This was primarily due to a rise in the effective tax rate applied in Japan due to the termination of tax deductions for IT investments and reduction of tax credit for R&D expenses. Also, the increase is partially due to the previous year, which saw a temporary decrease in income taxes due to tax effect accounting applied to some foreign consolidated subsidiaries.

Income before minority interests

Income before minority interests for the year ended March 31, 2007 increased by ¥9.7 billion, or 4.7%, to ¥215.8 billion from the previous fiscal year. Minority interests for the year ended March 31, 2007 increased by ¥0.5 billion, or 10.2%, to ¥5.0 billion from the previous fiscal year.

Net income

As a result of the above factors, net income for the year ended March 31, 2007 increased by ¥9.2 billion, or 4.6%, to ¥210.8 billion from the previous fiscal year.

Year Ended March 31, 2006 Compared to Year Ended March 31, 2005

Net sales

Net sales for the year ended March 31, 2006 decreased by ¥26.9 billion, or 0.6%, to ¥4,637.7 billion. Net sales amounts described below represent amounts after the elimination of intersegment transactions.

• Domestic tobacco business

Net sales for the domestic tobacco business are comprised of domestic sales (including duty-free sales) of tobacco products manufactured by the group in or outside Japan and of products manufactured by foreign tobacco manufacturers and distributed by our subsidiaries as wholesalers, and sales in the China, Hong Kong and Macau markets, which are generated by JT's China Division. The group's net sales for the domestic tobacco business were ¥3,405.3 billion, a decrease of ¥86.2 billion, or 2.5%, in net sales from the previous fiscal year. The sales volume of JT's tobacco products in Japan decreased by 23.7 billion cigarettes, or 11.2%, to 189.4 billion cigarettes from the previous fiscal year. Sales volume declined despite of the positive effect of the increased sales volume of JTI products such as Camel, Winston, and Salem sold in Japan since May 2005. The decline was mainly due to the continued decrease in the total demand for cigarettes caused by the aging Japanese population, growing consciousness of smoking and health and tightened smoking regulations. The decline in sales volume was also accelerated by the termination of the license agreement for Marlboro products in Japan at the end of April 2005. The sales volume of tobacco products in Japan excluding Marlboro products and including Camel, Winston, and Salem (on a like-for-like basis for comparability) decreased by 7.6 billion cigarettes or 3.9% from the previous fiscal year.

• International tobacco business

Net sales in the international tobacco business were ¥881.2 billion, an increase of ¥88.5 billion, or 11.2% from the previous fiscal year. The sales volume of our international tobacco business increased by 7.9 billion cigarettes, or 3.7%, to 220.3 billion cigarettes. Sales of GFB increased by 2.4 billion cigarettes, or 1.8%, to 133.8 billion cigarettes. The sales volume and GFB sales volume of our international tobacco business excluding the Japan market (on a like-for-like basis for comparability) increased by 13.0 billion cigarettes, or 6.3%, and 6.9 billion cigarettes, or 5.6%, from the previous fiscal year, respectively. Net sales in U.S. dollars increased due to a sales volume increase, positive impacts of market and product mix, and the imposition of higher tobacco excise taxes in some markets. Sales denominated in foreign currencies are initially translated into U.S. dollars, and then translated into Japanese yen using the 12-month average exchange rate. Net sales in U.S. dollars increased due to the weakness of the U.S. dollar, and the weakness of the Japanese yen against the U.S. dollar also contributed to the net sales increase. The average exchange rates between the Japanese yen and U.S. dollar used for the calculation was ¥108.23 to $1.00 for the year ended March 31, 2005 and ¥110.26 to $1.00 for the year ended March 31, 2006.

• Pharmaceutical business

Net sales in the pharmaceutical business decreased by ¥8.4 billion, or 14.6%, to ¥49.3 billion for the year ended March 31, 2006 from the previous fiscal year. Despite the one-time income from the licensing of anti-HIV agent JTK-303 to US-based Gilead Sciences, net sales decreased principally due to a decrease in royalty revenue from the anti-HIV viral drug Viracept, a decrease in net sales of Torii, and the lack of one-time income from the licensing of JTT-705 (dyslipidemia), as was recorded in the previous fiscal year.

• Foods business

Net sales in the foods business increased by ¥13.0 billion, or 4.9%, to ¥278.4 billion from the previous fiscal year. Net sales in the processed foods business increased by ¥5.2 billion, or 5.9%, to ¥93.0 billion as a result of business expansion in the frozen processed foods and chilled processed foods businesses. Net sales in the beverage business increased by ¥7.8 billion, or 4.4%, to ¥185.4 billion, mainly due to the continued expansion of the beverage vending machine sales channel.

• Others

Net sales in other businesses decreased by ¥33.7 billion, or 58.9%, to ¥23.6 billion, primarily due to a decrease in the number of consolidated subsidiaries as a result of the transfer of their shares to other parties.

Cost of sales

For the year ended March 31, 2006, cost of sales increased by ¥20.3 billion, or 0.5%, to ¥3,734.1 billion from the previous fiscal year,

principally as a result of the increase in sales volume of our international tobacco business, the purchase of Marlboro products by our subsidiary due to the end of JT's manufacturing license for these products at the end of April 2005, and the business volume expansion in the foods business. This increase was largely offset by a decrease in sales volume of our domestic tobacco business and the positive impact of business restructuring measures implemented in the previous fiscal year.

Selling, general and administrative expenses

For the year ended March 31, 2006, selling, general and administrative expenses decreased by ¥80.8 billion, or 11.9%, to ¥596.6 billion from the previous fiscal year. The decrease was primarily due to a decrease in personnel expenses resulting mainly from business restructuring measures implemented in the previous fiscal year and a decrease in royalty payments for Marlboro products as a result of the license agreement terminated at the end of April 2005.

Operating income

As a result of the foregoing factors, operating income increased by ¥33.6 billion, or 12.3%, to ¥306.9 billion. Operating income by business segment was as follows:

• Domestic tobacco business

Operating income in the domestic tobacco business for the year ended March 31, 2006 increased by ¥4.3 billion, or 2.0%, to ¥220.1 billion from the previous fiscal year, in spite of the termination of the license agreement for Marlboro products in Japan at the end of April 2005. The increase reflected a decrease in personnel expenses resulting mainly from business restructuring measures implemented in the previous fiscal year and an increase in the average unit price of cigarettes including the effects of Camel, Winston, and Salem sold by JT in Japan since May 2005.

• International tobacco business

Operating income in the international tobacco business for the year ended March 31, 2006 increased by ¥26.6 billion, or 59.8%, to ¥71.0 billion from the previous fiscal year. This was primarily due to an increase in sales volume associated with a unit price increase. The weakness of the U.S. dollar and the weakness of the Japanese yen against the U.S. dollar also contributed to this increase.

• Pharmaceutical business

For the year ended March 31, 2006, in spite of the decrease in research and development expenses and the one-time income from the licensing of anti-HIV agent JTK-303, we recorded an operating loss of ¥5.1 billion, a decrease of ¥6.9 billion from the previous fiscal year. This was primarily due to a decrease in the royalty revenue from Viracept, a decrease in sales of Torii, and the one-time income from the licensing of JTT-705 (dyslipidemia) in the previous fiscal year.

• Foods business

For the year ended March 31, 2006, operating income increased by ¥4.4 billion, or 224.7%, to ¥6.3 billion from the previous fiscal year. This was primarily due to an improvement of margins resulting from business expansion and a reduction of fixed costs resulting from efficient operation.

• Others

For the year ended March 31, 2006, operating income decreased by ¥1.8 billion, or 16.8%, to ¥8.7 billion from the previous fiscal year. This was primarily due to a decline in the number of consolidated subsidiaries as a result of the transfer of their shares to other parties.

Other expenses, net

Other expenses, net, were ¥6.0 billion, a decrease of ¥166.1 billion for the year ended March 31, 2006 from the previous fiscal year. This was primarily due to the decrease in business restructuring costs including additional retirement benefits in relation to a voluntary retirement program.

Income before income taxes and minority interests

As a result of the above factors, income before income taxes and minority interests for the year ended March 31, 2006 increased by ¥199.7 billion, or 197.0%, to ¥301.0 billion from the previous fiscal year.

Income taxes

Income taxes for the year ended March 31, 2006 increased by ¥63.3 billion, or 200.6%, to ¥94.9 billion from the previous fiscal year. For the year ended March 31, 2006, the actual effective tax rate increased by 0.4 percentage points to 31.5%. This was primarily due to a rise in higher taxed income in the composition of JT's income before income taxes.

Income before minority interests

Income before minority interests for the year ended March 31, 2006 increased by ¥136.3 billion, or 195.4%, to ¥206.1 billion from the previous fiscal year. Minority interest for the year ended March 31, 2006 decreased by ¥2.6 billion, or 36.6%, to ¥4.6 billion from the previous fiscal year.

Net income

As a result of the above factors, net income for the year ended March 31, 2006 increased by ¥139.0 billion, or 222.0%, to ¥201.5 billion from the previous fiscal year.

Liquidity and Capital Resources

In our financial management, we strive to maintain a stable financial base from which capital expenditures, acquiring outside resources, and research and development activities can be conducted in a cost-efficient and effective manner to grow our businesses without being affected by short-term fluctuations of revenues. We raise the required funds principally from cash flows provided by operations, borrowings from financial institutions and issuances of long-term bonds.

Cash Flows

• Overview

As of March 31, 2006 and March 31, 2007, cash and cash equivalents totaled ¥920.1 billion and ¥1,179.5 billion, respectively.

	Millions of yen			Millions of U.S. dollars
For years ended March 31	2005	2006	2007	2007
Net cash provided by operating activities	¥ 250,840	¥ 150,343	¥ 435,958	$ 3,693
Net cash provided by (used in) investing activities	176,914	(26,358)	(149,692)	(1,268)
Net cash used in financing activities	(202,196)	(48,135)	(32,635)	(277)
Effect of exchange rate changes and other	1,868	15,205	5,749	49
Net increase in cash and cash equivalents	227,426	91,055	259,380	2,197
Cash and cash equivalents at beginning of the period	601,661	829,087	920,142	7,795
Cash and cash equivalents at end of the period	¥ 829,087	¥ 920,142	¥ 1,179,522	$ 9,992

Year Ended March 31, 2007 Compared to Year Ended March 31, 2006

Net cash provided by operating activities was ¥436.0 billion for the year ended March 31, 2007, in comparison with ¥150.3 billion for the year ended March 31, 2006. The increase was mainly due to the stable ability to generate cash flows in the tobacco business, an increase in Tobacco excise taxes payable as the closing date was not a business day, and a decrease in retirement payments regarding a voluntary retirement program.

Net cash used in investment activities was ¥149.7 billion for the year ended March 31, 2007, in comparison with ¥26.4 billion used for the year ended March 31, 2006. Despite an increase in proceeds from the sales and redemptions of securities, an increase in outlays for Gallaher's securities purchased caused an increase in cash used.

Net cash used in financing activities was ¥32.6 billion for the year ended March 31, 2007, compared to ¥48.1 billion for the year ended March 31, 2006. A decrease in net cash used was primarily due to proceeds from increases in short-term debt of our subsidiaries, despite an increase in dividends paid.

Year Ended March 31, 2006 Compared to Year Ended March 31, 2005

Net cash provided by operating activities was ¥150.3 billion for the year ended March 31, 2006, in comparison with ¥250.8 billion for the year ended March 31, 2005. Although our tobacco business operations generate stable cash flows, there was a payment of additional retirement benefits in relation to a voluntary retirement program implemented in the previous fiscal year.

Net cash used in investing activities was ¥26.4 billion for the year ended March 31, 2006, while net cash of ¥176.9 billion was provided by investing activities for the year ended March 31, 2005. This was primarily due to the purchase of short-term financial assets maturing over three months in the year ended March 31, 2006, as opposed to the redemption of short-term financial assets maturing over three months in the previous fiscal year.

Net cash used in financing activities was ¥48.1 billion for the year ended March 31, 2006, in comparison with ¥202.2 billion for the year ended March 31, 2005. The decrease in net cash used was primarily due to the lack of outlays related to the redemption of long-term bonds in the previous fiscal year.

Liquidity and Capital Requirements

Our principal capital and liquidity needs are for capital expenditures, working capital, acquiring outside resources, repayments of borrowings, and payments of interest, dividends and income taxes.

• Capital expenditures

Capital expenditures include machinery and equipment for factories, trademarks and other tangible and intangible assets required for enhancing productivity of our factories and other facilities, strengthening our competitiveness, and promoting businesses in various fields.

	Millions of yen			Millions of U.S. dollars
For years ended March 31	2005	2006	2007	2007
Capital expenditures	¥ 85,109	¥ 98,927	¥102,147	$ 865

For the year ended March 31, 2007, we invested a total of ¥102.1 billion in capital expenditures. In the domestic tobacco businesses, we had capital expenditures of ¥55.2 billion, principally to streamline product manufacturing processes, strengthen supply and demand response functions to cope with the diversification of products, enhance new product development, and install new vending machines. In the international tobacco business, we invested ¥32.0 billion mainly to increase production capacity. In the pharmaceutical business, we invested ¥3.0 billion to improve production and R&D facilities. In the foods business, we invested ¥4.9 billion primarily to strengthen production facilities. In other businesses, we invested ¥8.1 billion, principally to improve sales facilities.

For the year ended March 31, 2006, we invested ¥98.9 billion in capital expenditures. In the domestic and international tobacco businesses, we invested in capital expenditures of ¥75.0 billion and ¥25.0 billion, respectively, principally to streamline product manufacturing processes, strengthen supply and demand response functions to cope with the diversification of products, and to enhance new product development. In the pharmaceutical business, we invested ¥2.1 billion which included the improvement of production and R&D facilities. In the foods business, we invested ¥4.6 billion primarily to strengthen production facilities. In other busi-

nesses, we invested ¥19.3 billion principally for real estate development. The amount of capital expenditures invested in the domestic tobacco business includes goodwill in relation to the integration of the Japanese market business acquired from foreign tobacco business subsidiaries. This amount was eliminated together with other internal transactions in consolidation.

For the year ended March 31, 2005, we invested ¥85.1 billion in capital expenditures primarily to increase production capabilities. In the tobacco business, we invested ¥65.3 billion principally to boost the efficiency and flexibility of manufacturing operations and to enhance new product development. In the pharmaceutical business, we invested ¥3.1 billion for purposes such as the improvement of R&D facilities. In the foods business, we invested ¥7.4 billion primarily to strengthen manufacturing facilities. In other businesses, we invested ¥10.6 billion principally for sales facilities and office equipment.

For the year ending March 31, 2008, we plan to spend approximately ¥126.0 billion on capital expenditures. We plan to spend approximately ¥64.0 billion in the domestic tobacco business to improve productivity and reduce cost, and approximately ¥35.0 billion in the international tobacco business to increase production capacity. We plan to spend approximately ¥3.0 billion for improving pharmaceutical R&D facilities and functions, approximately ¥6.5 billion on foods production facilities, and approximately ¥ 17.0 billion for real estate development in other businesses.

Our actual capital expenditures might differ significantly from the above descriptions as a result of a number of factors including, but not limited to, those discussed in the "Major Risks of Businesses".

• Working capital

Our principal working capital requirements are for purchasing raw materials, including leaf tobacco and other inventory items, the payment of salaries and wages, selling expenses, advertising and promotion expenses, taxes, and research and development expenses.

• Acquiring outside resources

From time to time, we invest in or acquire companies that, we believe, have the potential to help us diversify our sources of cash flows and improve our profitability.

• Dividends

We also require sufficient liquidity to make our scheduled dividend payments. Our basic dividend policy is that we aim to provide a competitive level of returns to shareholders in consideration of the accomplishments of our mid to long-term growth strategies and the outlook of our consolidated financial results. We strive to increase the dividend level on a continuous basis with a targeted consolidated dividend payout ratio of 20%.

• Stock repurchases

Any repurchase of our own shares also requires cash outlays. In order to exercise flexible stock repurchases, we amended the articles of incorporation at the general shareholders' meeting held on June 24, 2004 to enable share repurchases based on the resolution of the Board of Directors. As of March 31, 2007, we hold 419,920 shares of common stock as treasury stock. We may hold the repurchased shares as treasury stock, cancel them, or utilize them for any other purpose. Stock repurchases provide our management with an additional option to increase flexibility and speed in capital management to meet the needs of a rapidly changing business environment. We will consider the timing, scale and manner of any further repurchases based upon the business needs and market trends.

• Stock splits

To create an environment where investors can invest more easily in our shares and to broaden investor base by lowering the price per share, we completed a five-for-one stock split on April 1, 2006.

Capital Resources and Use

We have historically had, and expect to continue to have, significant cash flows from operating activities. Cash provided by operating activities was ¥150.3 billion for the year ended March 31, 2006 and ¥436.0 billion for the year ended March 31, 2007. We expect that cash generated by operating activities will continue to cover capital expenditures and repayment of debt. For significant capital requirements related to acquiring outside resources, we may utilize debt financing, primarily borrowings from financial institutions and the issuance of bonds as needed. (See Long and Short-term Debt below.)

Equity financing, including warrants and bonds with warrants, requires the approval of the Minister of Finance under the Japan Tobacco Inc. Law. Revisions to the Japan Tobacco Inc. Law that took effect on April 19, 2002 provided us with the flexibility to issue new equity shares so long as we have the approval of the Minister of Finance and the Japanese government continues to hold more than one-third of the number of issued shares outstanding. We may choose to raise capital through stock issuance in the future, which would have a dilutive impact on the value of existing owners' equity.

Long and Short-term Debt

• Long-term debt

Our long-term liabilities consist mainly of long-term debt and liabilities for retirement benefits. As of March 31, 2007, long-term debt was ¥165.6 billion, of which ¥150.0 billion was in the form of bonds. The remaining long-term debt (including the current portion) consisted of loans from banks and life insurance companies. Annual interest rates applicable to yen denominated long-term bank loans outstanding at March 31, 2006 and 2007 ranged from 1.50% to 5.10%, and 1.50% to 5.20%, respectively. Annual interest rates for long-term loans denominated in other currencies ranged from 7.05% to 7.91% for those outstanding at March 31, 2006 and 6.30% to 8.37% for those outstanding at March 31, 2007.

Maturities of long-term debt (including the current portion) at March 31, 2007 were as follows:

For years ended March 31	Millions of yen	Millions of U.S. dollars
2008	¥ 10,550	$ 90
2009	1,398	12
2010	150,676	1,276
2011	672	6
2012	754	6
2013 and thereafter	1,513	13
Total	¥ 165,563	$ 1,403

As of March 31, 2007, our long-term debt was rated Aa3 by Moody's Investors Service, Inc. and A+ by Standard & Poor's Ratings Services. These ratings are among the highest ratings for international tobacco companies. By maintaining high credit ratings, we can finance large sums of capital at relatively low cost from third parties as needed. The ability to maintain high ratings is influenced by numerous factors such as developments in the principal markets in which we manage our business, the success of our business strategies, and general economic trends in Japan which are beyond our control. However, the ratings are not recommendations to purchase, sell or hold securities. The ratings might be withdrawn or modified at any time. Each rating should be evaluated separately from other ratings.

Under the Japan Tobacco Inc. Law, bonds issued by Japan Tobacco Inc. are secured by statutory preferential rights over the property of Japan Tobacco Inc. These rights give bondholders preference to unsecured creditors in seeking repayment, with the exception of national and local taxes and other statutory obligations.

In September 2002, in order to diversify our capital resources and enhance our debt financing capabilities, we established a medium-term note program in the Eurobond market allowing us to issue up to $5 billion. We may issue notes under this program, as needed, with board approval.

• **Short-term debt**

We use banks and other financial institutions for short-term loans. Short-term loans were ¥33.3 billion at March 31, 2006 and ¥53.7 billion at March 31, 2007, including foreign currency denominated loans of ¥33.0 billion and ¥53.5 billion, respectively. Annual interest rates applicable to yen denominated short-term bank loans outstanding at March 31, 2006 ranged from 0.47% to 1.50%, and from 1.625% to 1.875% at March 31, 2007. Annual interest rates ranged from 3.95% to 7.35% for short-term loans denominated in other currencies outstanding at March 31, 2006 and from 4.40% to 16.00% at March 31, 2007.

In Japanese commercial practice, short-term and long-term bank loans are made under general agreements which provide that, under certain circumstances, security and guarantees for present and future indebtedness will be given upon request of the bank, and that the bank shall have the right, as the obligations become due, or in the event of their default, to offset cash deposits against such obligations due to the bank. We have never been requested to provide such collateral.

Derivative Transactions

We are exposed to market risks principally from changes in interest rates, foreign exchange rates and equity and debt security prices. Our interest rate risk exposures primarily relate to financing activities. Our foreign currency exposures relate to buying, selling and financing in currencies other than the local currencies of our operation. In order to reduce foreign exchange rate risk and interest rate risk, we use derivative financial instruments including interest rate swaps, foreign currency forward contracts, currency swaps and option contracts. We do not hedge against price fluctuations of debt and equity securities.

We have risk management policies and procedures designed to mitigate the risks arising from exposures from the use of derivative financial instruments. We utilize derivatives solely for risk management purposes, and no derivatives are held or issued for trading purposes. As part of our risk management procedures, we identify the specific risks and transactions to be hedged and the appropriate hedging instruments to be used to reduce the risk, and then assess the correlation between the hedged risks and the hedging instruments. The effectiveness of our hedging activities is assessed in accordance with our risk management policies and practice manual for hedging transactions.

Also, we are exposed to credit-related risk in the event of nonperformance by counterparties to derivative financial instruments. However, we strive to mitigate this risk by limiting counterparties to international financial institutions with high credit ratings, with which we believe there is no significant risk of default.

We use interest rate swaps for the purpose of managing interest rate risk in relation to financing activities. Interest rate swap agreements that qualify for hedge accounting under Japanese GAAP and meet specific matching criteria are not measured at market value, but the differential to be paid or received under the swap agreement is accrued and included in interest expenses.

We use foreign currency forward contracts, currency swaps and currency option contracts for the purpose of managing the risk of fluctuations in foreign exchange rates on our borrowings, bonds and forecasted transactions in foreign currencies. Hedging contracts outstanding as of March 31, 2006 and March 31, 2007 held by JT and domestic subsidiaries qualify for hedge accounting. Therefore, gains or losses arising from changes in value of these contracts are deferred and recognized in the period in which corresponding losses or gains from transactions being hedged by such contracts are recognized. On the other hand, hedging contracts associated with our international tobacco operations do no qualify for hedge accounting and therefore we recognize changes in value of foreign currency derivative instruments against earnings in the period in which they occur. This could result in gains or losses from fluctuations in exchange rates related to a derivative contract being recognized in a period which may be different from the gains or losses recognized from the underlying forecasted transactions.

For information about the contract and notional amount of interest rate swaps, foreign currency forward contracts and currency option contracts outstanding as of March 31, 2006 and 2007 that did not qualify for hedge accounting, see Note 17 to the audited consolidated financial statements included in this annual report.

Consolidated Balance Sheets

Japan Tobacco Inc. and Consolidated Subsidiaries
Years ended March 31, 2006 and 2007

Assets	Millions of yen 2006	Millions of yen 2007	Millions of U.S. dollars (Note 2) 2007
Current assets:			
Cash and cash equivalents (Note 4)	¥ 920,142	¥ 1,179,522	$ 9,992
Short-term investments (Note 5)	59,516	6,167	52
Trade notes and accounts receivable	134,183	149,385	1,266
Inventories (Note 6)	406,832	417,276	3,535
Other current assets (Note 8)	89,257	89,997	762
Allowance for doubtful accounts	(1,776)	(1,539)	(13)
Total current assets	1,608,154	1,840,808	15,594
Property, plant and equipment (Note 7):			
Land	138,672	131,818	1,117
Buildings and structures	603,224	598,558	5,070
Machinery, equipment and vehicles	528,186	567,495	4,807
Tools	212,034	203,214	1,722
Construction in progress	21,715	28,212	239
Total	1,503,831	1,529,297	12,955
Accumulated depreciation	(907,287)	(928,861)	(7,869)
Net property, plant and equipment	596,544	600,436	5,086
Investments and other assets:			
Investment securities (Note 5)	105,363	260,211	2,204
Investments in and advances to unconsolidated subsidiaries and associated companies	2,664	2,405	20
Trademarks	190,587	154,981	1,313
Goodwill	355,184	360,682	3,055
Deferred tax assets (Note 8)	102,902	75,457	639
Other assets	77,805	71,282	604
Allowance for doubtful accounts	(1,293)	(1,231)	(10)
Allowance for loss on investments	(531)	(368)	(3)
Total investments and other assets	832,681	923,419	7,822
Total	¥ 3,037,379	¥ 3,364,663	$ 28,502

See notes to consolidated financial statements.

Liabilities and Equity	Millions of yen 2006	Millions of yen 2007	Millions of U.S. dollars (Note 2) 2007
Current liabilities:			
Short-term bank loans (Note 7)	¥ 33,292	¥ 53,706	$ 455
Current portion of long-term debt (Note 7)	18,204	10,550	90
Tobacco excise taxes payable (Note 9)	176,160	337,940	2,863
Trade notes and accounts payable	137,455	129,765	1,099
Other payable (Note 10)	119,675	93,568	793
Income taxes payable (Note 8)	31,992	60,108	509
Accrued bonuses	27,610	29,312	248
Consumption taxes payable	28,189	35,756	303
Other current liabilities (Notes 8 and 10)	53,779	62,491	529
Total current liabilities	626,356	813,196	6,889
Non-current liabilities:			
Long-term debt (Note 7)	165,112	155,013	1,313
Liabilities for retirement benefits (Note 10)	293,425	282,377	2,392
Deferred tax liabilities (Note 8)	46,178	43,436	368
Non-current other payable (Note 10)	54,876	11,755	100
Other non-current liabilities	31,359	34,270	290
Total non-current liabilities	590,950	526,851	4,463
Minority interests	57,561	—	—
Commitments and contingent liabilities (Note 14)			
Equity (Note 11):			
Common stock – authorized, 8,000,000 shares in 2006 and 40,000,000 shares in 2007; issued, 2,000,000 shares in 2006 and 10,000,000 shares in 2007	100,000	100,000	847
Capital surplus	736,400	736,400	6,238
Retained earnings	972,512	1,158,337	9,812
Unrealized gain on available-for-sale securities	35,532	33,330	282
Deferred gain on derivatives under hedge accounting	—	14,580	124
Pension liability adjustment of foreign consolidated subsidiaries	—	(15,560)	(132)
Foreign currency translation adjustments	(7,354)	7,745	66
Treasury stock, at cost — 419,920 shares in 2007 and 83,984 shares in 2006	(74,578)	(74,578)	(632)
Total	1,762,512	1,960,254	16,605
Minority interests	—	64,362	545
Total Equity	1,762,512	2,024,616	17,150
Total	¥ 3,037,379	¥ 3,364,663	$ 28,502

Consolidated Statements of Income

Japan Tobacco Inc. and Consolidated Subsidiaries
Years ended March 31, 2005, 2006 and 2007

	Millions of yen			Millions of U.S. dollars (Note 2)
	2005	2006	2007	2007
Net sales	¥ 4,664,514	¥ 4,637,657	¥ 4,769,387	$ 40,401
Cost of sales (Note 9)	3,713,725	3,734,074	3,844,768	32,569
Gross profit	950,789	903,583	924,619	7,832
Selling, general and administrative expenses (Note 12)	677,418	596,637	592,628	5,020
Operating income	273,371	306,946	331,991	2,812
Other income (expenses):				
Interest and dividend income	3,316	5,910	12,103	103
Gain on disposition of property, plant and equipment–net (Note 15)	57,458	22,881	33,952	287
Loss on impairment of long-lived assets (Note 15)	(182)	(11,439)	(2,712)	(23)
Interest expense (Note 7)	(5,147)	(5,776)	(6,940)	(59)
Business restructuring costs (Notes 10 and 15)	(224,848)	(8,009)	—	—
Other–net (Note 15)	(2,635)	(9,520)	(31,198)	(264)
Other income (expenses)—net	(172,038)	(5,953)	5,205	44
Income Before Income Taxes and Minority Interests	101,333	300,993	337,196	2,856
Income taxes (Note 8):				
Current	70,071	49,686	84,481	715
Deferred	(38,506)	45,210	36,924	313
Total income taxes	31,565	94,896	121,405	1,028
Income Before Minority Interests	69,768	206,097	215,791	1,828
Minority interests	7,184	4,555	5,019	43
Net income	¥ 62,584	¥ 201,542	¥ 210,772	$ 1,785

	Yen			U.S. dollars
	2005	2006	2007	2007
Amounts per share:				
Net income (Notes 3 (o) and 18)	¥ 32,090	¥ 105,085	¥ 22,001	$ 186
Cash dividends applicable to the year (Note 3 (o))	13,000	16,000	4,000	34

See notes to consolidated financial statements.

Consolidated Statements of Changes in Equity

Japan Tobacco Inc. and Consolidated Subsidiaries
Years ended March 31, 2005, 2006 and 2007

	Thousands	Millions of yen										
	Number of shares of common stock	Common stock	Capital surplus	Retained earnings	Unrealized gain on available-for-sale securities	Deferred gain on derivatives under hedge accounting	Pension liability adjustment of foreign consolidated subsidiaries	Foreign currency translation adjustments	Treasury stock	Total	Minority interests	Total equity
Balance, March 31, 2004	2,000	¥100,000	¥736,400	¥ 763,770	¥14,186	¥ —	¥ —	¥(71,840)	¥(34,579)	¥1,507,937	¥ —	¥1,507,937
Net income	—	—	—	62,584	—	—	—	—	—	62,584	—	62,584
Adjustments to retained earnings for change in scope of consolidation	—	—	—	(637)	—	—	—	—	—	(637)	—	(637)
Minimum pension liability adjustment of foreign consolidated subsidiaries	—	—	—	(9)	—	—	—	—	—	(9)	—	(9)
Appropriations:												
Cash dividends paid (¥10,000 per share)	—	—	—	(19,542)	—	—	—	—	—	(19,542)	—	(19,542)
Bonuses to directors and corporate auditors	—	—	—	(239)	—	—	—	—	—	(239)	—	(239)
Repurchase of common stock (38,184 shares)	—	—	—	—	—	—	—	—	(39,999)	(39,999)	—	(39,999)
Net increase in unrealized gain on available-for-sale securities	—	—	—	—	2,702	—	—	—	—	2,702	—	2,702
Net change in foreign currency translation adjustments	—	—	—	—	—	—	—	(14,593)	—	(14,593)	—	(14,593)
Balance, March 31, 2005	2,000	100,000	736,400	805,927	16,888	—	—	(86,433)	(74,578)	1,498,204	—	1,498,204
Net income	—	—	—	201,542	—	—	—	—	—	201,542	—	201,542
Minimum pension liability adjustment of foreign consolidated subsidiaries	—	—	—	(5,981)	—	—	—	—	—	(5,981)	—	(5,981)
Appropriations:												
Cash dividends paid (¥15,000 per share)	—	—	—	(28,740)	—	—	—	—	—	(28,740)	—	(28,740)
Bonuses to directors and corporate auditors	—	—	—	(236)	—	—	—	—	—	(236)	—	(236)
Net increase in unrealized gain on available-for-sale securities	—	—	—	—	18,644	—	—	—	—	18,644	—	18,644
Net change in foreign currency translation adjustments	—	—	—	—	—	—	—	79,079	—	79,079	—	79,079
Balance, March 31, 2006	2,000	¥100,000	¥736,400	¥ 972,512	¥35,532	¥ —	¥ —	¥ (7,354)	¥(74,578)	¥1,762,512	¥ —	¥1,762,512

Consolidated Statements of Changes in Equity

Japan Tobacco Inc. and Consolidated Subsidiaries
Years ended March 31, 2005, 2006 and 2007

	Thousands	Millions of yen										
	Number of shares of common stock	Common stock	Capital surplus	Retained earnings	Unrealized gain on available-for-sale securities	Deferred gain on derivatives under hedge accounting	Pension liability adjustment of foreign consolidated subsidiaries	Foreign currency translation adjustments	Treasury stock	Total	Minority interests	Total equity
Balance, March 31, 2006	2,000	¥100,000	¥736,400	¥ 972,512	¥35,532	¥ —	¥ —	¥ (7,354)	¥(74,578)	¥1,762,512	¥ —	¥1,762,512
Reclassified balance as of March 31, 2006 (Note3 (p))	—	—	—	—	—	—	—	—	—	—	57,561	57,561
Stock split (Notes 11 and 18)	8,000	—	—	—	—	—	—	—	—	—	—	—
Net income	—	—	—	210,772	—	—	—	—	—	210,772	—	210,772
Minimum pension liability adjustment of foreign consolidated subsidiaries	—	—	—	9,818	—	—	—	—	—	9,818	—	9,818
Appropriations:												
Cash dividends paid (¥9,000 per share) for year ended 2006	—	—	—	(17,244)	—	—	—	—	—	(17,244)	—	(17,244)
Cash dividends paid (¥1,800 per share) for interim of year ended 2007	—	—	—	(17,244)	—	—	—	—	—	(17,244)	—	(17,244)
Bonuses to directors and corporate auditors	—	—	—	(197)	—	—	—	—	—	(197)	—	(197)
Adjustment to retained earnings for change in the number of equity method affiliates	—	—	—	(80)	—	—	—	—	—	(80)	—	(80)
Net Changes in the year	—	—	—	—	(2,202)	14,580	(15,560)	15,099	—	11,917	6,801	18,718
Balance, March 31, 2007	10,000	¥100,000	¥736,400	¥1,158,337	¥33,330	¥14,580	¥(15,560)	¥ 7,745	¥(74,578)	¥1,960,254	¥64,362	¥2,024,616

	Millions of U.S. dollars (Note 2)										
	Common stock	Capital surplus	Retained earnings	Unrealized gain on available-for-sale securities	Deferred gain on derivatives under hedge accounting	Pension liability adjustment of foreign consolidated subsidiaries	Foreign currency translation adjustments	Treasury stock	Total	Minority interests	Total equity
Balance, March 31, 2006	$ 847	$ 6,238	$ 8,238	$ 301	$ —	$ —	$ (62)	$ (632)	$ 14,930	$ —	$ 14,930
Reclassified balance as of March 31, 2006 (Note3 (p))	—	—	—	—	—	—	—	—	—	488	488
Net income	—	—	1,785	—	—	—	—	—	1,785	—	1,785
Minimum pension liability adjustment of foreign consolidated subsidiaries	—	—	83	—	—	—	—	—	83	—	83
Appropriations:											
Cash dividends paid ($76 per share) for year ended 2006	—	—	(146)	—	—	—	—	—	(146)	—	(146)
Cash dividends paid ($15 per share) for interim of year ended 2007	—	—	(146)	—	—	—	—	—	(146)	—	(146)
Bonuses to directors and corporate auditors	—	—	(1)	—	—	—	—	—	(1)	—	(1)
Adjustment to retained earnings for change in the number of equity method affiliates	—	—	(1)	—	—	—	—	—	(1)	—	(1)
Net Changes in the year	—	—	—	(19)	124	(132)	128	—	101	57	158
Balance, March 31, 2007	$ 847	$ 6,238	$ 9,812	$ 282	$ 124	$ (132)	$ 66	$ (632)	$ 16,605	$ 545	$ 17,150

Consolidated Statements of Cash Flows

Japan Tobacco Inc. and Consolidated Subsidiaries
Years ended March 31, 2005, 2006 and 2007

	Millions of yen			Millions of U.S. dollars (Note 2)
	2005	2006	2007	2007
Operating Activities:				
Income before income taxes and minority interests	¥ 101,333	¥ 300,993	¥ 337,196	$ 2,856
Adjustments for:				
Income taxes paid	(73,037)	(59,015)	(57,185)	(484)
Depreciation and amortization other than goodwill	125,862	124,855	130,106	1,102
Amortization of goodwill	882	1,590	2,537	21
Gain on disposition of property, plant and equipment	(57,458)	(22,881)	(33,952)	(288)
Loss on impairment of long-lived assets	182	11,439	2,712	23
Write-down of investment securities	362	11	—	—
Change in assets and liabilities:				
Decrease (increase) in trade notes and accounts receivable	(4,423)	765	(9,476)	(80)
Decrease (increase) in inventories	16,995	44,091	(6,171)	(52)
Increase (decrease) in tobacco excise taxes payable	(10,736)	(13,973)	160,020	1,355
Increase (decrease) in trade notes and accounts payable	4,597	20,260	(12,878)	(109)
Increase (decrease) in other payable	141,778	(125,689)	(22,088)	(187)
Decrease in liabilities for retirement benefits	(95,978)	(6,591)	(21,164)	(179)
Increase (decrease) in long-term guarantee deposit received	(26,224)	631	(2,479)	(21)
Increase (decrease) in non-current other payable	122,244	(87,377)	(43,142)	(365)
Other — net	4,461	(38,766)	11,922	101
Total adjustments	149,507	(150,650)	98,762	837
Net cash provided by operating activities	250,840	150,343	435,958	3,693
Investing Activities:				
Purchases of short-term investments	(57,560)	(146,467)	(332,975)	(2,821)
Proceeds from sale and redemption of short-term investments	222,414	122,118	386,816	3,277
Purchases of investment securities	(7,671)	(2,734)	(158,385)	(1,342)
Proceeds from sale and redemption of investment securities	3,064	4,342	5,345	45
Purchases of property, plant and equipment	(71,997)	(82,850)	(96,717)	(819)
Proceeds from sale of property, plant and equipment	39,448	82,147	57,094	484
Proceeds from sale of beneficial interest in real estate trust	65,109	—	—	—
Purchases of trademarks and other assets	(7,964)	(8,966)	(7,928)	(67)
Purchases of shares of newly consolidated subsidiaries, net of cash acquired	—	(1,400)	(4,085)	(35)
Other — net	(7,929)	7,452	1,143	10
Net cash provided by (used in) investing activities	176,914	(26,358)	(149,692)	(1,268)
Financing Activities:				
Net increase in short-term bank loans	4,935	1,552	18,571	157
Proceeds from issuance of long-term debt	237	—	—	—
Repayments of long-term debt	(147,135)	(19,474)	(19,840)	(168)
Proceeds from issuance of common stock to minority shareholders	—	—	4,928	42
Dividends paid	(19,542)	(28,740)	(34,488)	(292)
Dividends paid to minority shareholders	(1,827)	(1,468)	(1,474)	(13)
Repurchase of common stock	(39,999)	—	—	—
Other — net	1,135	(5)	(332)	(3)
Net cash used in financing activities	(202,196)	(48,135)	(32,635)	(277)
Foreign Currency Translation Adjustments on Cash and Cash Equivalents	1,868	15,205	5,749	49
Net Increase in Cash and Cash Equivalents	227,426	91,055	259,380	2,197
Cash and Cash Equivalents, Beginning of Year	601,661	829,087	920,142	7,795
Cash and Cash Equivalents, End of Year	¥ 829,087	¥ 920,142	¥ 1,179,522	$ 9,992

Notes to Consolidated Financial Statements

Japan Tobacco Inc. and Consolidated Subsidiaries

1. Business

Japan Tobacco Inc. ("JT") is a joint stock corporation (*kabushikikaisha*) incorporated under the corporate law of Japan (the "Corporate Law") pursuant to the Japan Tobacco Inc. Law (the "JT Law"). JT is primarily engaged in the manufacture and sale of tobacco products in the domestic and international markets as one of the largest producers of tobacco products in the world. The total sales of cigarettes of JT and its consolidated subsidiaries (the "JT Group" or "Group") in the fiscal year ended March 31, 2007, excluding tobacco products purchased from overseas tobacco manufacturers and sold to retail stores through its logistic subsidiary, TS Network Co., Ltd. ("TS Network"), was 418.4 billion cigarettes (174.9 billion cigarettes in the domestic market; 3.4 billion cigarettes in the domestic duty-free market and the markets in China, Hong Kong, and Macau where JT operates in the tobacco business; and 240.1 billion cigarettes in other overseas markets).

In the domestic tobacco market, JT manufactures and sells its tobacco products to retail stores all over the country in accordance with the Tobacco Business Law. The Tobacco Business Law provides that (1) JT shall be the sole manufacturer of tobacco products in Japan and (2) the maximum wholesale price of each tobacco product manufactured and sold and the retail price of every product sold in Japan, as well as any changes in these prices, shall be approved by the Minister of Finance. The products are transported from its factories to its distribution bases by its logistic subsidiary, JT Logistics Co., Ltd., and then distributed to the retail stores through TS Network which also purchases and sells tobacco products of foreign tobacco manufacturers to retail stores as wholesalers in the domestic market.

JT greatly expanded its international tobacco business through the acquisition of the non-U.S. tobacco operations of RJR Nabisco, Inc. ("RJR Nabisco") on May 12, 1999. In connection with this acquisition, JT paid $5.0 billion to purchase the non-U.S. tobacco operations of RJR Nabisco, which resulted in $3.5 billion of goodwill. JT also acquired non-U.S. tobacco-related trademarks and intellectual property for $2.7 billion and other assets for $0.1 billion. The acquisition, totaling $7.8 billion, was financed by a syndicated loan of $5.0 billion, which was refinanced through domestic and foreign bond issues and long-term loans from banks and insurance companies, and $2.8 billion in cash. JT repaid in full the long-term loans from banks and redeemed foreign bonds by July 2004. JT has been constantly repaying long-term loans from insurance companies. Domestic bonds are expected to be redeemed in June 2009. As a result of this acquisition, JT obtained expanded access to overseas markets, especially in Europe and Russia, and the rights in substantially all countries outside the United States to internationally recognized trademarks such as *Camel*, *Winston* and *Salem*, which currently comprise JT's global flagship brands along with *Mild Seven*, which JT developed. JT International S.A. ("JTISA") and other consolidated subsidiaries of JT International Holding B.V. ("JT International"), a wholly-owned subsidiary of JT, conduct the overseas tobacco business of the JT Group.

Mitsubishi Corporation ("Mitsubishi") (except for Okinawa Prefecture) and Kokuba-Gumi Co., Ltd. ("Kokuba") (Okinawa) imported the newly acquired brands including *Camel*, *Winston* and *Salem*, from JTISA to Japan, and sold them through TS Network (in Okinawa, through Kokuba). The JT Group terminated its contracts with Mitsubishi and Kokuba regarding import and distribution of these products at the end of April 2005. Since then, JT imports, manufactures and sells these products by itself in Japan.

From 1973, JT had manufactured and sold Marlboro brand cigarettes in Japan under a license arrangement with Philip Morris Products S.A. Upon the expiration of the license term in April 2005, JT ceased the production and sale of Marlboro brand cigarettes.

In addition to the tobacco business, the JT Group has diversified into and is developing other business segments in the areas of pharmaceutical and foods primarily through acquisitions, investments and licensing arrangements.

In the pharmaceutical business, the JT Group focuses on the research and development of prescription drugs. In the domestic market, Torii Pharmaceutical Co., Ltd., a majority of whose outstanding shares JT acquired for ¥42 billion in December 1998, manufactures and sells prescription drugs using its wide marketing network. In the overseas market, JT principally receives royalties from licensing arrangements of an anti-HIV drug.

In the foods business, the JT Group principally manufactures and sells beverages, processed foods and seasonings in the domestic market. As for chilled foods, the operation is mainly conducted through its subsidiary, Hans Continental Smallgoods Pty. Ltd., in Australia. JT's presence in the beverage market was substantially expanded through the acquisition of a majority of the outstanding shares of Unimat Corporation, a nationwide operator of soft drink vending machines, later renamed as Japan Beverage Inc., for ¥29 billion in April and September 1998. Additionally, JT acquired the food business of Asahi Kasei Corporation for ¥24 billion in July 1999.

According to the JT Law, JT must obtain approval from the Minister of Finance for certain matters, such as (1) the issuance of new shares (as well as subscription rights for new shares (*shinkabuyoyakuken*) and bonds with subscription rights for new shares) and (2) the resolution of shareholders meetings for any amendments to the Articles of Incorporation and appropriations of retained earnings. Pursuant to the JT Law, the Japanese government is required to hold one-half or more of JT's shares which were originally issued upon the establishment of JT in 1985. The amended JT Law also authorizes JT to issue new shares to the extent that the number of shares held by the Minister of Finance continues to account for more than one-third of the issued shares.

2. Basis of Presenting Consolidated Financial Statements

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in Japan ("Japanese GAAP") and in accordance with the provisions set forth in the Securities and Exchange Law of Japan and its related accounting regulations (collectively, the "Securities Law"), which are different in certain respects from application and disclosure requirements of accounting principles generally accepted in the United States of America ("U.S. GAAP") and International Financial Reporting Standards. In the case of most foreign consolidated subsidiaries, their financial statements are prepared in conformity with U.S. GAAP (see Note 3 (n) Foreign Consolidated Subsidiaries) and are included in the consolidated financial statements on that basis.

On December 27, 2005, the Accounting Standards Board of Japan (the "ASBJ") published a new accounting standard for the statement of changes in equity, which is effective for fiscal years ending on or after May 1, 2006. The statement of shareholder's equity, which was previously voluntarily prepared in line with the international accounting practices, is now required under Japanese GAAP and had been renamed "the statement of changes in equity" in the current fiscal year.

In preparing these consolidated financial statements, certain reclassifications and rearrangements have been made to the consolidated financial statements issued domestically in order to present them in a form which is more familiar to readers outside Japan. In addition, the notes to the consolidated financial statements include information which is not required under Japanese GAAP but is presented herein as additional information. Certain reclassifications of previously reported amounts have been made to conform with classifications for the year ended March 31, 2007.

The consolidated financial statements are stated in Japanese yen, the currency of the country in which JT is incorporated and operates. The translations of Japanese yen amounts into U.S. dollar amounts are included solely for the convenience of readers outside Japan and have been made at the rate of ¥118.05 to $1, the rate of exchange at March 31, 2007. Such translations should not be construed as representations that the Japanese yen amounts could be converted into U.S. dollars at that or any other rate.

3.Summary of Significant Accounting Policies

a) Consolidation

The consolidated financial statements as of March 31, 2007 include the accounts of JT and its 153 significant (160 as of March 31, 2005 and 157 as of March 31, 2006) subsidiaries. Consolidation of the remaining unconsolidated subsidiaries would not have had a material effect on the accompanying consolidated financial statements. Most foreign consolidated subsidiaries have a December 31 fiscal year-end, which differs from the March 31 fiscal year-end of JT. Any necessary adjustments for the three-month period are made for consolidation purposes.

Investments in 11 material associated companies as of March 31, 2007 (10 as of March 31, 2005 and 11 as of March 31, 2006) are accounted for by the equity method. The equity method is not applied to account for the investments in unconsolidated subsidiaries and the remaining associated companies, since the effect on the accompanying consolidated financial statements would not have been material. Investments in the unconsolidated subsidiaries and the remaining associated companies are stated at cost (see (c) Securities).

All significant inter-company balances and transactions have been eliminated in consolidation. All material unrealized gains resulting from inter-company transactions have been eliminated.

The excess of the cost of the Company's investments in consolidated subsidiaries over its equity in (prior to April 1, 1999) or the fair value of (from April 1, 1999) the net assets purchased at the date of acquisition is recorded as goodwill. Goodwill, except for that recorded at JT International Group (see (n) Foreign Consolidated Subsidiaries), is amortized on a straight-line basis over five to twenty years. Such amortization expense is included in selling, general and administrative expenses. However, insignificant goodwill is charged to income when incurred.

b) Cash Equivalents

Cash equivalents are all short-term, highly liquid investments that are convertible to known amounts of cash and that have original maturities of three months or less.

c) Securities

The Company's securities are classified as held-to-maturity debt securities or available-for-sale securities, depending on management's holding intent. Held-to-maturity debt securities are reported at amortized cost. Available-for-sale marketable securities are reported at fair value, with unrealized gains and losses, net of applicable taxes, reported in a separate component of equity.

The cost of available-for-sale marketable securities sold is determined based on the moving-average method. In addition, compound financial instruments, including embedded derivatives which cannot be measured separately, are reported at fair value in aggregate, with these gains and losses reported in the consolidated statements of income. Non-marketable available-for-sale securities are stated at cost determined by the moving-average method. For significant impairment in value which is judged unrecoverable, carrying amounts of securities are reduced to fair value, with a resulting charge to income. An allowance for loss on investments is recorded to provide for the loss on investments in certain non-marketable equity accounted for by the cost method and is determined based on the respective financial condition of the investees.

d) Inventories

Inventories are stated principally at average cost. In addition, leaf tobacco held by JT is subject to devaluation (see Note 6). Leaf tobacco is classified as a current asset, although part of such inventories, due to the duration of the aging process, will not ordinarily be put into production within one year.

e) Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is generally computed using the declining-balance method while the straight-line method is applied to buildings acquired after April 1, 1998. The useful lives of buildings and structures, and machinery, equipment and vehicles are principally from 38 to 50 years and 8 years, respectively.

Under certain conditions, such as exchanges of similar fixed assets, sales and purchases resulting from expropriation and acquisitions made with the benefit of a government subsidy, Japanese tax laws permit companies to defer the profit arising from such transactions by reducing the cost of the assets acquired or by providing a special reserve in equity. The costs of the acquired assets resulting from expropriation for the years ended March 31, 2005 was reduced by ¥17,396 million.

f) Impairment of Long-Lived Assets

In August 2002, the Business Accounting Council issued a Statement of Opinion, "Accounting for Impairment of Fixed Assets," and in October 2003 the Accounting Standards Board of Japan ("ASBJ") issued ASBJ Guidance No.6, "Guidance for Accounting Standard for Impairment of Fixed Assets." These new pronouncements are effective for fiscal years beginning on or after April 1, 2005. The group adopted the new accounting standard for impairment of fixed assets as of April 1, 2005.

The group reviews its long-lived assets for impairment whenever events or changes in circumstance indicate the carrying amount of an asset or asset group may not be recoverable. An impairment loss would be recognized if the carrying amount of an asset or asset group exceeds the sum of the undiscounted future cash flows expected to result from the continued use and eventual disposition of the asset or asset group. The impairment loss would be measured as the amount by which the carrying amount of the asset exceeds its recoverable amount, which is the higher of the discounted cash flows from the continued use and eventual disposition of the asset or the net selling price at disposition.

g) Intangible Assets

Trademarks are carried at cost less accumulated amortization, which is calculated by the straight-line method principally over 10 years.

h) Income Taxes

The provision for income taxes is computed based on the pretax income or loss included in the consolidated statements of operations. The asset and liability approach is used to recognize deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities, and tax operating loss and other credit carry-forwards. Deferred taxes are measured by applying currently enacted tax laws to the temporary differences, tax operating loss and other credit carry-forwards. A valuation allowance is provided for any portion of the deferred tax assets where it is considered more likely than not that they will not be realized.

i) Liabilities for Retirement Benefits

(1) Employees' retirement benefits

JT has an unfunded severance indemnity plan and a cash balance pension plan (the "Pension Plans") as well as a defined contribution plan, which cover substantially all of its employees (including executive officers who are not directors). Its consolidated subsidiaries principally have unfunded severance indemnity plans and/or non-contributory defined pension plans.

The Pension Plans and the subsidiaries' plans are stated based on actuarially estimated retirement benefit obligations, considering the estimated fair value of plan assets at each balance sheet date. Certain domestic subsidiaries apply a simplified method, under which retirement benefit obligations are recorded based on the amount required if all employees terminated their employment as of the balance sheet date. Contributions to the defined contribution plan are charged to expenses when they are paid or accrued.

Liabilities for retirement benefits to directors and corporate auditors are provided at the amount which would be required if all directors and corporate auditors retired at each balance sheet date.

(2) Obligations under the Public Official Mutual Assistance Association Law

As a formerly wholly government-owned company, JT is obligated by the Public Official Mutual Assistance Association Law to reimburse the Japanese government for pension expenses incurred each year by the government for former employees of Japan Tobacco and Salt Public Corporation, JT's predecessor entity, and others for their services during certain periods before July 1, 1956. Effective April 1, 2003, such obligations have been recognized as a liability at their present value using the actuarially determined computation method. Prior to April 1, 2003, they were charged to expenses based on the annual cash payments in respect of claims for reimbursement invoiced to JT by the Social Insurance Agency.

j) Leases

All leases are accounted for as operating leases. Under Japanese accounting standards for leases, finance leases that are deemed to transfer ownership of the leased property to the lessee are to be capitalized, while other finance leases are permitted to be accounted for as operating lease transactions if certain "as if capitalized" information is disclosed in the notes to the lessee's financial statements.

k) Appropriations of Retained Earnings

Appropriation of retained earnings are reflected in the financial statements for the following year upon shareholders' approval.

l) Foreign Currency Transactions

Receivables and payables denominated in foreign currencies are translated into Japanese yen at the rates prevailing at each balance sheet date. The exchange gains or losses from translation are recognized in the consolidated statements of income to the extent that hedging derivative financial instruments for foreign currency transactions do not qualify for hedge accounting (see (m) Derivatives).

All assets and liabilities of foreign consolidated subsidiaries are translated into Japanese yen at the exchange rates at each subsidiary's respective fiscal year end. All revenue and expense accounts are translated at average exchange rates during each subsidiary's respective fiscal year. The resulting translation adjustments are reported as a separate component of equity.

m) Derivatives

All derivatives, except for certain foreign exchange forward contracts, foreign currency option contracts and interest rate swap contracts described below, are recognized as either assets or liabilities and measured at fair value, and gains or losses on derivative transactions are recognized in the consolidated statements of income.

For derivatives which qualify for hedge accounting because of high correlation and effectiveness between the hedging instruments and the hedged items, gains or losses on derivatives are deferred until the corresponding hedged items are recognized in earnings.

JT's trade payables that are denominated in foreign currencies and have been hedged by foreign exchange forward contracts are translated at the foreign exchange rate stipulated in the contracts. Interest rate swaps that qualify for hedge accounting and meet specific matching criteria are not remeasured at market value, but the differential to be paid or received under the swap agreements are accrued and included in interest expense or income.

n) Foreign Consolidated Subsidiaries

JTISA and other foreign consolidated subsidiaries principally maintain their accounting records in conformity with U.S. GAAP. The significant accounting policies, which are different from JT's policies, are as follows:

(1) Inventories

Inventories are generally stated at the lower of cost or market, cost being determined by the first-in, first-out method or average cost.

(2) Property, plant and equipment

Depreciation of property, plant and equipment is generally computed using the straight-line method over the estimated useful lives of the respective assets.

(3) Goodwill and trademarks

Goodwill arising from the acquisitions including foreign subsidiaries of RJR Nabisco and recorded at JT International Group is not subject to amortization but is tested for impairment at least annually.

As a result of the change in the useful life from 40 years to 20 years for Canadian trademark, trademarks are principally amortized using straight-line method over 20 years for the fiscal year ended March 31, 2007.

(4) Retirement benefit pension plans

The difference between the obligation for retirement benefits and the fair value of plan assets is recognized on the consolidated balance sheet for the year ended March 31, 2007 as assets/liabilities (see (q) Accounting Change, The adoption of new accounting standards). Unrecognized net actuarial loss and prior service cost, net of applicable taxes, is recorded as a part of equity as pension liability adjustment of foreign consolidated subsidiaries. Prior to the above accounting change, if the liability for retirement benefits already recognized was less than the unfunded accumulated benefit obligation, an additional minimum liability was recognized. The additional minimum liability was charged directly to retained earnings, if such amount exceeded unrecognized prior service cost, net of any tax benefits.

(5) Derivatives

All derivatives are used to hedge foreign exchange risk and are recognized as either assets or liabilities in the balance sheet and measured at fair value. Changes in the fair value of derivatives are recorded in current earnings for each fiscal year.

o) Per Share Information

Each share of common stock was split into five shares on April 1, 2006 (see Note 11 Equity). Basic net income per share is computed by dividing net income available to common shareholders, by the weighted-average number of common shares outstanding in each period, which were 1,942,901 shares and 1,916,016 shares for the year ended March 31, 2005 and 2006, respectively, not retroactively adjusted for the stock split.

Diluted net income per share is not disclosed because there were no potentially dilutive common shares that were outstanding during the three years in the period ended March 31, 2007.

Cash dividends per share presented in the consolidated statements of income are dividends applicable to the respective years including dividends to be paid after the end of the year, not retroactively adjusted for stock split.

p) Presentation of Equity

On December 9, 2005, the ASBJ published a new accounting standard for presentation of equity.

Under this accounting standard, certain items which were previously presented as liabilities are now presented as components of equity. Such items include minority interests and any deferred gains or losses on derivatives accounted for under hedge accounting. This standard is effective for fiscal years ending on or after may 1, 2006.

The consolidated balance sheet as of March 31, 2007 is presented in line with this new accounting standards. Japanese GAAP does not permit the restatement of prior years to reflect the changes introduced by this standard.

q) Accounting Change

The adoption of new accounting standards

Accounting Standards for Bonuses to Directors –

On November 29, 2005, the ASBJ Japan (ASBJ) issued ASBJ

Statement No.4, "Accounting Standards for Bonuses to Directors" which is effective for fiscal years beginning on or after April 1, 2006. The group adopted the new accounting standard for bonuses to Directors as of April 1, 2006.

This application has no material impact on operating income, recurring profit, or income before income taxes and minority interests.

Accounting for Retirement Benefits of Foreign Consolidated Subsidiaries –

As for JT's foreign consolidated subsidiaries, if the liability for retirement benefits already recognized fell below the unfunded accumulated benefit obligation, an additional minimum liability was originally recognized. However, from the fiscal year that ended March 31, 2007, according to FASB Statement 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132 (R)", the accounting policies were changed to state the difference of retirement benefits obligation and fair value of plan assets on consolidated balance sheets as assets/liabilities, and to state unrecognized net actuarial loss and prior service cost, net of applicable taxes, as a part of equity as pension liability adjustment of foreign consolidated subsidiaries. The change had no impact on profits for the consolidated fiscal year that ended March 31, 2007.

r) New Accounting Pronouncements

Measurement of Inventories –

On July 5, 2006, the ASBJ issued ASBJ Statement No.9, "Accounting Standard for Measurement of Inventories", which is effective for fiscal years beginning on or after April 1, 2008 with early adoption permitted.

This statement requires that inventories held for sale in the ordinary course of business be measured at the lower of cost or net selling value, which is defined as the selling price less additional estimated manufacturing costs and estimated direct selling expenses. The replacement cost may be used in place of the net selling value, if appropriate. The standard also requires that inventories held for trading purposes be measured at the market price.

Lease accounting –

On March 31, 2007, the ASBJ issued ASBJ Statement No.13, "Accounting Standard for Lease Transactions", which revised the existing accounting standard for lease transactions issued on June 17, 1993.

Under the existing accounting standard, finance leases that deem to transfer ownership of the leased property to the lessee are to be capitalized, however, other finance leases are permitted to be accounted for as operating lease transactions if certain "as if capitalized" information is disclosed in the note to the lessee's financial statements.

The revised accounting standard requires all finance lease transactions to be capitalized. The revised accounting standard for lease transactions is effective for fiscal years beginning on or after April 1, 2008 with early adoption permitted for fiscal years beginning on or after April 1, 2007.

Unification of Accounting Policies Applied to Foreign Subsidiaries for the Consolidated Financial Statements –

Under Japanese GAAP, a company currently can use the financial statements of foreign subsidiaries which are prepared in accordance with generally accepted accounting principles in their respective jurisdictions for its consolidation process unless they are clearly unreasonable. On May 17, 2006, the ASBJ issued ASBJ Practical Issues Task Force (PITF) No.18, "Practical Solution on Unification of Accounting Policies Applied to Foreign Subsidiaries for the Consolidated Financial Statements". The new task force prescribes: 1) the accounting policies and procedures applied to a parent company and its subsidiaries for similar transactions and events under similar circumstances should in principle be unified for the preparation of the consolidated financial statements, 2) financial statements prepared by foreign subsidiaries in accordance with either International Financial Reporting Standards or the generally accepted accounting principles in the United States tentatively may be used for the consolidation process, 3) however, the following items should be adjusted in the consolidation process so that net income is accounted for in accordance with Japanese GAAP unless they are not material;

(1) Amortization of goodwill
(2) Actuarial gains and losses of defined benefit plans recognized outside profit or loss
(3) Capitalization of intangible assets arising from development phases
(4) Fair value measurement of investment properties, and the revaluation model for property, plant and equipment, and intangible assets
(5) Retrospective application when accounting policies are changed
(6) Accounting for net income attributable to a minority interest

The new task force is effective for fiscal years beginning on or after April 1, 2008 with early adoption permitted.

4.Cash and Cash Equivalents

Cash and cash equivalents include gensaki transactions, securities purchased under repurchase agreements. The fair value of such securities received as collateral from the counterparty at March 31, 2006 and 2007 were ¥79,975 million and ¥51,970 million ($440 million), respectively.

5. Short-Term Investments and Investment Securities

Short-term investments and investment securities at March 31, 2006 and 2007 consisted of the following:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Short-term investments:			
Time deposits	¥ 497	¥ 2,216	$ 19
Government and Corporate bonds	58,617	3,720	31
Trust fund investments and other	402	231	2
Total	¥ 59,516	¥ 6,167	$ 52
Investment securities:			
Equity securities	¥ 92,912	¥ 246,713	$ 2,090
Government and Corporate bonds	3,036	3,146	26
Trust fund investments and other	9,415	10,352	88
Total	¥ 105,363	¥ 260,211	$ 2,204

"Government and Corporate bonds" in Investment securities on the consolidated balance sheet as of March 31, 2006 included compound financial instruments whose gains and losses including those of embedded derivatives were recorded in the consolidated statements of income.

The costs and aggregate fair values of marketable securities at March 31, 2006 and 2007 were as follows:

	Millions of yen			
	2006			
	Cost	Unrealized gain	Unrealized loss	Fair value
Available-for-sale				
Equity securities	¥ 33,016	¥ 57,524	¥ 253	¥ 90,287
Corporate bonds	37,401	259	3	37,657
Trust fund investments and other	5,150	3,069	3	8,216
Held-to-maturity				
Government bonds and municipal bonds	1,497	0	10	1,487
Others	1,002	—	3	999

	Millions of yen			
	2007			
	Cost	Unrealized gain	Unrealized loss	Fair value
Available-for-sale				
Equity securities	¥ 192,141	¥ 51,337	¥ 1,037	¥ 242,441
Corporate bonds	2,085	79	—	2,164
Trust fund investments and other	4,191	6,161	—	10,352
Held-to-maturity				
Government bonds and municipal bonds	1,199	0	5	1,194
Others	502	—	1	501

	Millions of U.S. dollars			
	2007			
	Cost	Unrealized gain	Unrealized loss	Fair value
Available-for-sale				
Equity securities	$ 1,628	$ 435	$ 9	$ 2,054
Corporate bonds	18	0	—	18
Trust fund investments and other	36	52	—	88
Held-to-maturity				
Government bonds and municipal bonds	10	0	0	10
Others	4	—	0	4

The carrying amounts of non-marketable securities at March 31, 2006 and 2007 were as follows:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Available-for-sale			
Equity securities	¥ 2,625	¥ 4,273	$ 36
Corporate bonds	21,500	3,002	25
Trust fund investments and other	1,598	229	3
Total	¥ 25,723	¥ 7,504	$ 64

Proceeds from sales of available-for-sale securities and related gross realized gains and losses on those sales, computed on the moving average cost basis for the years ended March 31, 2005, 2006 and 2007, were as follows:

	Millions of yen			Millions of U.S. dollars
	2005	2006	2007	2007
Proceeds from sales	¥ 2,878	¥ 3,262	¥ 9,229	$ 78
Gross realized gains	¥ 1,455	¥ 959	¥ 2,125	$ 18
Gross realized losses	(342)	(9)	(3)	(0)
Net realized gain	¥ 1,113	¥ 950	¥ 2,122	$ 18

The amounts of securities classified as available-for-sale and held-to-maturity at March 31, 2007, based on their contractual maturity dates, were as follows:

	Millions of yen		Millions of U.S. dollars	
	Available for sale	Held-to-maturity	Available for sale	Held-to-maturity
Due within one year	¥ 3,020	¥ 302	$ 25	$ 2
Due after one year through five years	11,996	1,399	102	12
Due after five years through ten years	2	—	0	—
Due after ten years	—	—	—	—
Total	¥ 15,018	¥ 1,701	$ 127	$ 14

For the years ended March 31, 2005 and 2006, losses on write-downs of securities including investments in affiliated companies totaled ¥1,836 million and ¥11 million, respectively. In evaluating securities values, a security, whose value has declined by more than 50% is considered to have experienced “significant deterioration.” A security, whose value has declined from 30% to 50% and the effect of the decline on JT’s financial position is material, is considered to have experienced “significant deterioration.” If a security has a strong chance of regaining its value, such security is not written down.

6. Inventories

Inventories at March 31, 2006 and 2007 consisted of the following:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Leaf tobacco	¥ 274,549	¥ 278,567	$ 2,360
Finished products	44,512	49,736	421
Other	87,771	88,973	754
Total	¥ 406,832	¥ 417,276	$ 3,535

JT leaf tobacco inventory in excess of the minimum amount necessary for future production is subject to annual devaluation. The net effect of the change in the devaluation was debited (credited) to cost of sales as follows:

	Millions of yen			Millions of U.S. dollars
	2005	2006	2007	2007
Net effect of the change in devaluation (credit)	¥ 9,856	¥ 9,588	¥ (9,585)	$ (81)

7. Short-term Bank Loans and Long-term Debt

Short-term bank loans as of March 31, 2006 and 2007 consisted of the following:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Yen loans with interest rates of 0.47% to 1.50% at March 31, 2006 and of 1.625% to 1.875% at March 31, 2007	¥ 300	¥ 160	$ 1
Foreign currency loans with interest rates of 3.95% to 7.35% at March 31, 2006 and of 4.40% to 16.00% at March 31, 2007	32,992	53,546	454
Total	¥ 33,292	¥ 53,706	$ 455

Long-term debt at March 31, 2006 and 2007 comprised the following:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
1.98% yen bonds, due 2009	¥ 150,000	¥ 150,000	$ 1,271
Long-term bank loans due through 2015	33,316	15,563	132
Total	183,316	165,563	1,403
Less current portion	(18,204)	(10,550)	(90)
Long-term debt, less current portion	¥ 165,112	¥ 155,013	$ 1,313

JT entered into interest rate swap agreements in March 2004 to convert interest payments on 1.98% yen bonds due 2009 to floating rate payments on a LIBOR basis, which was at 1.24% at March 31 2005, in order to manage interest rate risks on these bonds. Taking changes in market conditions into consideration, JT unwound the above interest swap agreements in May 2005. Consequently, JT now pays a fixed rate interest of 1.61%.

In addition, certain domestic consolidated subsidiaries had entered into interest rate swap agreements to fix variable rate interest payments of Japanese yen loans. Annual interest rates applicable to Japanese yen long-term loans of JT and certain domestic consolidated subsidiaries at March 31, 2006 and 2007 ranged from 1.50% to 5.10% and 1.50% to 5.20%, respectively.

Annual interest rates applicable to long-term loans denominated in foreign currencies outstanding at March 31, 2006 and 2007 ranged from 7.05% to 7.91% and 6.30% to 8.37%, respectively.

Annual maturities of long-term debt at March 31, 2007 were as follows:

Years ending March 31,	Millions of yen	Millions of U.S. dollars
2008	¥ 10,550	$ 90
2009	1,398	12
2010	150,676	1,276
2011	672	6
2012	754	6
2013 and thereafter	1,513	13
Total	¥ 165,563	$ 1,403

Under the JT Law, obligations created by the bonds issued by JT are secured by a statutory preferential right over the property of JT. This right entitles the holders thereof to claim satisfaction in preference to unsecured creditors (with the exception of national and local taxes and certain other statutory obligations).

Substantially all of the short-term bank loans and long-term debt are unsecured. Secured loans and debt of certain consolidated subsidiaries at March 31, 2007 were as follows:

	Millions of yen	Millions of U.S. dollars
Long-term bank loans	¥ 3,002	$ 25
Others, principally short-term bank loans	3,127	27
Total	¥ 6,129	$ 52

The carrying amounts of assets pledged as collateral for the above secured loans and debt at March 31, 2007 were as follows:

	Millions of yen	Millions of U.S. dollars
Buildings and structures	¥ 5,056	$ 43
Machinery, equipment and vehicles	7,892	67
Other	1,066	9
Total	¥ 14,014	$ 119

General agreements with respective banks provide, as is customary in Japan, that additional collateral must be provided under certain circumstances if requested by such banks and that certain banks have the right to offset cash deposited with them against any long-term or short-term debt or other debt payable to the banks. JT has never been requested to provide additional collateral.

8. Income Taxes

JT and its domestic consolidated subsidiaries are subject to Japanese corporate tax, inhabitants tax and enterprise tax based on income which, in the aggregate, resulted in a normal effective statutory tax rate of approximately 40.35% for the years ended March 31, 2005, 2006 and 2007. Foreign consolidated subsidiaries are subject to income taxes of the countries in which they operate.

The tax effects of significant temporary differences and loss carry-forwards which resulted in deferred tax assets and liabilities at March 31, 2006 and 2007 were as follows:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Deferred tax assets:			
Liabilities for employees' retirement benefits	¥ 36,526	¥ 37,678	$ 319
Obligations under the Public Official Mutual Assistance Association Law	59,966	55,655	471
Net operating loss carryforwards	19,638	16,854	143
Other payable for benefits to retired employees	30,356	10,794	91
Other	61,853	59,975	509
Less valuation allowance	(14,110)	(20,370)	(173)
Total	194,229	160,586	1,360
Deferred tax liabilities:			
Deferred gain on sales of fixed assets for income tax purposes	(32,079)	(31,928)	(270)
Basis differences in assets acquired and liabilities assumed upon acquisition	(36,433)	(34,255)	(290)
Unrealized gain on available-for-sale securities	(24,905)	(23,170)	(196)
Other	(15,327)	(23,286)	(198)
Total	(108,744)	(112,639)	(954)
Net deferred tax assets	¥ 85,485	¥ 47,947	$ 406

Net deferred tax assets at March 31, 2006 and 2007 were reflected on the accompanying consolidated balance sheets under the following captions:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Other current assets	¥ 32,324	¥ 18,172	$ 154
Deferred tax assets	102,902	75,457	639
Other current liabilities	(3,563)	(2,245)	(19)
Deferred tax liabilities	(46,178)	(43,436)	(368)
Net deferred tax assets	¥ 85,485	¥ 47,948	$ 406

A reconciliation between the normal effective statutory tax rates for the years ended March 31, 2005, 2006 and 2007 and the actual effective tax rates reflected in the accompanying consolidated statements of operations was as follows:

	2005	2006	2007
Normal effective statutory tax rate	40.35%	40.35%	40.35%
Tax rate difference applied for foreign consolidated subsidiaries	(14.42)	(9.13)	(6.99)
Tax credits	(4.26)	(1.09)	(0.83)
Non-deductible expenses	5.19	1.86	3.06
Other - net	4.29	(0.46)	0.41
Actual effective tax rate	31.15%	31.53%	36.00%

9. Tobacco Excise Taxes

JT is subject to national and local tobacco excise taxes (per unit tax) on its tobacco products sold in the domestic market. JT's domestic distribution service subsidiary is also subject to the local tobacco excise tax (per unit tax) on its wholesale of foreign brand tobacco products purchased from foreign tobacco manufacturers through importers, while the national tobacco excise tax is paid by importers and charged to this subsidiary. In accordance with the amendment of the tobacco excise tax which became effective on and after July 1, 2006, the national tobacco excise tax and the local tobacco excise tax on cigarettes increased by ¥426 per thousand units, respectively. At March 31, 2007, subject to a few minor exceptions, the national tobacco excise tax, the local tobacco excise tax and the national tobacco special excise tax on cigarettes are ¥3,552 per thousand units, ¥4,372 per thousand units and ¥820 per thousand units, respectively, for a total tobacco excise tax of ¥8,744 per thousand units. Foreign subsidiaries are also subject to excise taxes on cigarettes sold in their domiciles. The aggregate amount of such tobacco excise taxes included in cost of sales for the years ended March 31, 2005, 2006 and 2007 were ¥2,650,586 million, ¥2,628,878 million and ¥2,718,358 million ($23,027 million), respectively, including national tobacco excise taxes paid by importers of ¥283,787 million, ¥371,227 million and ¥397,443 million ($3,367 million), respectively.

At March 31, 2007, Tobacco excise taxes payable includes the amount of ¥140,638 million ($1,191 million) which was unsettled because financial institutions were closed for holiday at the end of the fiscal year.

10. Liabilities for Retirement Benefits

(1) Employees' retirement benefit

JT has an unfunded severance indemnity plan and a cash balance pension plan as well as a defined contribution plan. The unfunded severance indemnity plan provides lump-sum retirement benefits based on credits earned in each year of service. Employees are entitled to receive larger payments in certain circumstances such as involuntary termination, retirement at the mandatory retirement age, voluntary termination at certain specific ages prior to mandatory retirement age or death. The cash balance pension plan provides retirement benefits in the form of a lump-sum payment or annuity payments based on current and past principal credits earned and interest credits over time based on these principal credits.

Domestic consolidated subsidiaries principally have unfunded severance indemnity plans and/or defined benefit pension plans covering substantially all of their employees, under which benefits are provided based on the rate of pay at the time of termination, years of service and certain other factors.

Foreign consolidated subsidiaries principally sponsor non-contributory defined benefit pension plans covering most of their employees. Plans covering regular full-time employees provide pension benefits based on credits, determined by age, years of service and final average compensation before retirement.

The liabilities for employees' retirement benefits at March 31, 2006 and 2007 consisted of the following:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Projected benefit obligations	¥ (309,038)	¥ (322,121)	$ (2,729)
Fair value of plan assets	193,133	203,484	1,724
Funded status	(115,905)	(118,637)	(1,005)
Unrecognized actuarial net loss (gain)	7,947	(17,535)	(149)
Unrecognized prior service cost	(257)	27,349	232
Loss on partial termination of defined benefit plan (see Note15)	(3,097)	—	—
Net amount recognized	(111,312)	(108,823)	(922)
Minimum pension liability adjustments (see Note3 (q))	(14,955)	—	—
Pension liability adjustment of foreign consolidated subsidiaries (see Note3 (q))	—	(18,721)	(159)
Prepaid pension cost	(18,543)	(18,897)	(160)
Other current liabilities	—	1,995	17
Liabilities for employees' retirement benefits	¥ (144,810)	¥ (144,446)	$ (1,224)

As described in Note3 (q) Accounting change, "Pension liability adjustment of foreign consolidated subsidiaries" is the unfunded obligation recognized by foreign consolidated subsidiaries applying U.S.GAAP. "Other current liabilities" is the amount by which the actuarial present value of benefits included in the benefit obligation payable in the next 12 months exceeds the fair value of plan assets in foreign consolidated subsidiaries applying U.S.GAAP.

The amount of minimum pension liability reversed by foreign consolidated subsidiaries applying U.S.GAAP was recorded in "Minimum pension liability adjustment of foreign consolidated subsidiaries" of retained earnings.

JT transferred a portion of the unfunded severance indemnity plan to the defined contribution plan on April 1, 2006, and thereby recognized ¥3,097 million for the year ended March 31, 2006 as other expense which led to an increase of liabilities for retirement benefits by the same amount in accordance with "Accounting for the Transfer between Retirement Benefits Plans (ASBJ Guideline No.1)" and "Practical Solution on Accounting for Transfer Between Retirement Benefit Plans (Practical Issues Task Forces Report No.2)".

	Millions of yen
	2006
Settlement of projected benefit obligations	¥ 4,567
Prior service cost recognized in earnings	(199)
Actuarial gain recognized in earnings	139
Decrease in liabilities for retirement benefits	4,507
Related assets due to be transferred to defined contribution plan	(7,604)
Loss on partial termination of defined benefit plan	¥ (3,097)

Related assets of ¥7,604 million due to be transferred to defined contribution plan will be paid in installment by 2009.

The components of net periodic retirement benefit cost for the years ended March 31, 2005, 2006 and 2007 were as follows:

	Millions of yen			Millions of U.S. dollars
	2005	2006	2007	2007
Service cost	¥ 13,015	¥ 9,278	¥ 9,684	$ 82
Interest cost	11,282	9,409	9,685	82
Expected return on plan assets	(4,720)	(5,823)	(6,829)	(58)
Recognized actuarial loss	3,378	1,718	315	3
Amortization of prior service cost	526	541	1,502	13
Net periodic retirement benefit costs	¥ 23,481	¥ 15,123	¥ 14,357	$ 122

Significant assumptions used for the years ended March 31, 2005, 2006 and 2007 were as follows:

	2005	2006	2007
Discount rate	2.5%	2.5%	2.5%
Expected rate of return on plan assets	2.0%	2.5%	2.5%

Actuarial gains or losses that result from changes in plan experience and actuarial assumptions are principally amortized over 10 years. The amortization period for the prior service cost that resulted from retroactive application of a plan amendment is principally 10 years. The retirement benefit attributable to each year is calculated by assigning the same amount of pension benefits to each year of service.

The Company's contributions, including those of certain foreign consolidated subsidiaries, to the defined contribution plans which were charged to expenses, for the years ended March 31, 2005, 2006 and 2007 were ¥2,750 million, ¥2,212 million and ¥3,002 million ($25 million), respectively.

JT has offered additional retirement benefits to its employees under the early retirement programs as a part of various business restructuring efforts in order to rationalize operating efficiencies in administrative and other headquarter functions and to reduce costs in the domestic tobacco business. These efforts principally related to closure of eight cigarette factories and a company-wide offering of an early retirement plan to employees who are age 40 or older with more than 15 years of services during the year ended March 31, 2005 and other business restructuring during the year ended March 31, 2006. Certain domestic and foreign subsidiaries also provided additional retirement benefits for early-retired employees in connection with the reorganization of domestic distribution operations or rationalization of other businesses during these periods. These restructuring activities resulted in recognition of additional retirement benefits as business restructuring costs of ¥209,540 million and ¥8,557 million for the years ended March 31, 2005 and 2006, respectively, and as other expenses of ¥790 ($7 million) for the year ended March 31, 2007, which included a one-time charge for the unrecognized actuarial net loss and unrecognized prior service cost attributable to the employees who retired earlier than expected.

Due to the retirement of a large number of employees during the year ended March 31, 2005, JT applied accounting standard for partial termination of defined benefit plans with the following effects reflected in the consolidated financial statements for the year ended March 31, 2005.

	Millions of yen
	2005
Settlement of projected benefit obligations	¥ 88,695
Prior service cost recognized in earnings	(625)
Actuarial loss recognized in earnings	(70)
Decrease in liabilities for retirement benefits	¥ 88,000

Related payables to employees who applied the early retirement programs including additional retirement benefits of JT were reported as other payable and non-current other payable, which would be paid over by 2008.

Certain domestic consolidated subsidiaries participate in multiemployer contributory pension plans, the required contributions to which are recognized as a net pension cost for the year. Plan assets allocated based on amounts contributed as of March 31, 2006 and 2007 were ¥5,346 million and ¥5,926 million ($50 million), respectively.

Certain foreign consolidated subsidiaries also provide certain health and life insurance benefits for retired employees and their dependents.

The retirement benefits paid to directors and corporate auditors are subject to approval by resolution at the shareholders meeting. The Company's liabilities for retirement benefits for directors and corporate auditors as of March 31, 2006 and 2007 were ¥900 million and ¥1,018 million ($9 million), respectively.

(2) Obligation under the Public Official Assistance Association Law

Employees of JT, including former employees of Japan Tobacco and Salt Public Corporation ("JTSPC"), JT's predecessor entity before the privatization in 1985, and others, are entitled to receive benefits under the government-sponsored pension plan by the Public Official Mutual Assistance Association Law (the "Law"). The benefits, in the form of lifetime annuity payments by the Social Insurance Agency, are determined based on the standard pay rate, the length of service and other factors. As a formerly wholly government-owned company, JT is obligated by the Law to reimburse the Japanese government for pension expenses incurred each year by the government in respect of former employees of JTSPC and others for their services during certain periods before July 1, 1956, the enactment date of the Law.

Such obligations were first recorded as liabilities at April 1, 2003 based on the actuarially determined computation method. Any actuarial gain or loss arising subsequent to April 1, 2003 is deferred and amortized over 10 years.

The liabilities and costs recognized for such obligations as of and for the year ended March 31, 2005, 2006 and 2007 were as follows:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Benefit obligations	¥ (152,534)	¥ (139,569)	$ (1,182)
Unrecognized actuarial loss	3,919	1,638	14
Liabilities recognized	¥ (148,615)	¥ (137,931)	$ (1,168)

	Millions of yen			Millions of U.S. dollars
	2005	2006	2007	2007
Interest cost	¥ 2,546	¥ 2,488	¥ 2,288	$ 19
Recognized actuarial (loss) gain	(254)	586	425	4
Net periodic costs	¥ 2,292	¥ 3,074	¥ 2,713	$ 23

The assumed discount rate used in the actuarial computation for the years ended March 31, 2005, 2006 and 2007 was 1.5%.

11. Equity

On and after May 1, 2006, Japanese companies are subject to a new corporate law of Japan (the "Corporate Law"), which reformed and replaced the Commercial Code of Japan (the "Code") with various revisions that are, for the most part, applicable to events or transactions which occur on or after May 1, 2006 and for the fiscal years ending on or after May 1, 2006. The significant changes in the Corporate Law that affect financial and accounting matters are summarized below:

(1) Dividends

Under the Corporate Law, companies can pay dividends at any time during the fiscal year in addition to the year-end dividend upon resolution at the shareholders meeting, if companies meet certain criteria such as; (1) having the Board of Directors, (2) having independent auditors, (3) having the Board of Corporate Auditors, and (4) the term of service of the directors is prescribed as one year rather than two years of normal term by its articles of incorporation. The Board of Directors of such company may declare dividends (except for dividends in kind) at any time during the fiscal year if the company has prescribed so in its articles of incorporation.

Semiannual interim dividends may also be paid once a year upon resolution by the Board of Directors if the articles of incorporation of the company so stipulate. The Corporate Law provides certain limitations on the amounts available for dividends or the purchase of treasury stock.

(2) Increases / decreases and transfer of common stock, reserve and surplus

The Corporate Law requires that an amount equal to 10% of dividends must be appropriated as a legal reserve (a component of retained earnings) or as additional paid-in capital (a component of capital surplus) depending on the equity account charged upon the payment of such dividends until the total of aggregate amount of legal reserve and additional paid-in capital equals 25% of the common stock. Under the Corporate Law, the total amount of additional paid-in capital and legal reserve may be reversed without limitation of such threshold. The Corporate Law also provides that common stock, legal reserve, additional paid-in capital, other capital surplus and retained earnings can be transferred among the accounts under certain conditions upon resolution of the shareholders.

(3) Treasury stock

The Corporate Law also provides for companies to purchase treasury stock and dispose of such treasury stock by resolution of the Board of Directors. The amount of treasury stock purchased cannot exceed the amount available for distribution to the shareholders which is determined by specific formula.

Upon the meeting of the board of directors held on February 27, 2006, JT decided to split the company's shares on five for one basis with the effective date of April 1, 2006.

The Special Taxation Measures Law in Japan permits companies to take as tax deductions certain reserves if provided through year-end book closing. Under Japanese tax laws, these reserves must be reversed to income in future years. The deferred gain on sales of fixed assets, net of tax effects, included in retained earnings provided under the Special Taxation Measures Law at March 31, 2006 and 2007 were ¥61,354 million and ¥51,130 million ($433 million), respectively.

12. Research and Development Costs and Advertising Costs

Research and development costs charged to expenses as incurred for the years ended March 31, 2005, 2006 and 2007 were ¥40,541 million, ¥37,505 million and ¥41,239 million ($349 million), respectively.

Advertising costs were charged to expenses as incurred and totaled ¥167,608 million, ¥166,093 million and ¥ 151,523 million ($1,284 million) for the years ended March 31, 2005, 2006 and 2007, respectively.

13. Lease Transactions

The Company, as a lessee, leases certain vehicles, vending machines and other assets. Total rental expenses under the above leases for the years ended March 31, 2005, 2006 and 2007 were ¥5,559 million, ¥5,117 million and ¥4,836 million ($41 million), respectively.

Pro forma information of leased property, such as acquisition cost, accumulated depreciation and obligations under finance leases that do not transfer ownership of the leased property to the lessee on an "as if capitalized" basis at March 31, 2006 and 2007 was as follows:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Acquisition cost:			
Machinery, equipment and vehicles	¥ 4,722	¥ 5,150	$ 43
Tools	17,769	18,495	157
Others	2,455	2,455	21
Total acquisition cost	24,946	26,100	221
Accumulated depreciation	12,277	11,605	98
Net leased property	¥ 12,669	¥ 14,495	$ 123

The above acquisition cost includes related interest expenses.

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Obligations under finance leases:			
Due within one year	¥ 4,182	¥ 4,463	$ 38
Due after one year	8,487	10,032	85
Total	¥ 12,669	¥ 14,495	$ 123

The above obligations under finance leases included related interest expenses. Pro forma depreciation expenses for the years ended March 31, 2005, 2006 and 2007, which have not been reflected in the accompanying consolidated statements of operations, computed by the straight-line method, were ¥5,559 million, ¥5,117 million and ¥4,836 million ($41 million), respectively.

The minimum rental commitments under noncancellable operating leases at March 31, 2006 and 2007 were as follows:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Due within one year	¥ 4,189	¥ 4,511	$ 38
Due after one year	10,151	9,919	84
Total	¥ 14,340	¥ 14,430	$ 122

The Company, as a lessor, leases certain computer equipment and other assets. Total lease revenue under the above leases for the years ended March 31, 2005, 2006 and 2007 was ¥377 million, ¥279 million and ¥253 million ($2 million), respectively.

Information of leased property included in the accompanying financial statements, such as acquisition cost, accumulated depreciation and claims under finance leases that do not transfer ownership of the leased property to the lessee, at March 31, 2006 and 2007 was as follows:

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Acquisition cost:			
Machinery, equipment and vehicles	¥ 546	¥ 100	$ 1
Tools	753	1,336	11
Total acquisition cost	1,299	1,436	12
Accumulated depreciation	862	594	5
Net leased property	¥ 437	¥ 842	$ 7

	Millions of yen		Millions of U.S. dollars
	2006	2007	2007
Claims under finance leases:			
Due within one year	¥ 187	¥ 290	$ 3
Due after one year	295	634	5
Total	¥ 482	¥ 924	$ 8

The above claims under finance leases included related interest income.

Depreciation expenses for the years ended March 31, 2005, 2006 and 2007 which have been reflected in the accompanying consolidated statements of income were ¥335 million, ¥250 million and ¥240 million ($2 million), respectively.

14. Commitments and Contingencies

(As of May 25, 2007)

The Tobacco Business Law and related regulations govern JT's domestic leaf tobacco procurement. The Tobacco Business Law requires JT to enter into advance purchase contracts annually with each domestic tobacco grower who intends to cultivate leaf tobacco for sale to JT. These contracts specify the total cultivation area for each variety of leaf tobacco and the prices of leaf tobacco by variety and grade. JT is obliged to purchase all leaf tobacco produced pursuant to these contracts which is suitable for the manufacture of tobacco products.

Before conclusion of the contracts, JT is required to consult with the Leaf Tobacco Deliberative Council (Hatabako-shingi-kai), a deliberative body organized under the Tobacco Business Law to provide their opinion to JT as to the aggregate cultivation area for each variety of leaf tobacco and the prices for leaf tobacco by variety and grade. JT is legally required to respect the opinion of the council. The council is charged with examining and deliberating important matters relating to the production and purchase of domestically produced leaf tobacco. The council consists of members appointed by JT with the approval of the Minister of Finance from among representatives of domestic leaf tobacco growers and various academic appointees. The council is obliged to provide its opinion as to the appropriate prices of leaf tobacco based on the level which would allow continued domestic production of leaf tobacco, by taking into account economic conditions such as production costs and commodity prices.

Domestic tobacco growers typically entrust the Japan Tobacco Growers Association (Zenkoku-tabakokosaku-kumiai-chuo-kai) with negotiation of the fundamental terms of their contracts with JT, including the purchase price of tobacco. JT enters into a common agreement with the association regarding fundamental contractual terms. The common agreement also includes disaster relief provisions which require JT to pay money to domestic tobacco growers whose tobacco plants or crops suffer from natural disasters. Pursuant to these provisions and based on the degree of damages, JT pays a maximum of 50% of the figure calculated by multiplying each cultivator's agreed cultivation area for the disaster year by their average procurement price per acreage for previous years.

JT's Canadian subsidiary, JTI-Macdonald received a Notice of Assessment from the Quebec Ministry of Revenue (QMR) demanding payment of approximately CAD 1.36 billion (approximately 114.6 billion yen at the then-exchange rate) in duties, penalties and interest in relation to being accused of conducting contraband activities from 1990 to 1998, in the period in which the

company was named RJR-Macdonald, before JT purchased the tobacco operations for countries other than the US from RJR Nabisco (RJR).

JTI-Macdonald filed an application to the Ontario Superior Court of Justice in August 2004 under the "Companies' Creditors Arrangement Act (CCAA)" because JTI-Macdonald's failing to pay the tax bill immediately would have allowed the QMR to confiscate JTI-Macdonald's business assets. This could have prevented JTI-Macdonald from continuing its business operations. CCAA protection makes it possible for JTI-Macdonald to continue business operations normally with its assets safeguarded at least through May 30, 2008. In order to repay a part of its borrowings from other subsidiaries of JT, JT International Holding B.V., Dutch subsidiary of JT, provided a letter of credit corresponding to the repayment, issued by a financial institute to a court-appointed monitor in April 2006.

Pursuant to the 1999 Purchase Agreement between JT and RJR, JT's view is that it will be entitled to seek indemnification from RJR (current Reynolds American Inc., and other successors) for any damages and expenses incurred by JTI-Macdonald arising out of this matter. JT intends to exercise such right.

In July 2004, ZAO JTI Marketing and Sales ("M&S Corp."), which oversees distribution-related businesses in the Russian market, received an assessment from the Moscow tax authorities in which it was ordered to pay approximately 2.4 billion rubles (approximately 8.8 billion yen at the then-exchange rate) for unpaid VAT and other taxes, interest and additional taxes for the period of January 2000 to December 2000.

M&S Corp. believes that the assessment from the Moscow tax authorities is based upon a misconstrued interpretation of the facts and lodged a suit with the Moscow Arbitration Court for the tax assessment to be invalidated. However, in September 2005, the Federal Arbitration Court for the Moscow District (cassation court) dismissed the appeal. M&S Corp. appealed to the Russian Federation Higher Arbitration Court in November 2005, and it reversed the previous decisions taken by the lower courts and returned the entire case to the Moscow Arbitration Court of the first instance in April 2006, where the action is pending.

15. Other Income (Expenses)

(1) Gain on disposition of property, plant and equipment-net

For the year ended March 31, 2005, gain on disposition of property, plant and equipment-net included a ¥42,868 million gain on the sale of a beneficial interest in the real estate trust to Frontier Real Estate Investment Corp. (FRI) with respect to six large commercial properties that JT owned. FRI was listed on the Tokyo Stock Exchange on August 9, 2004. At March 31, 2007, the Company holds seven per cent of FRI's equity interest and FRI is not included in the consolidation.

(2) Business restructuring costs

Business restructuring costs for the years ended March 31, 2005 and 2006 consisted of the following:

	Millions of yen	
	2005	2006
Additional Retirement Benefits (see Note 10)	¥ (209,540)	¥ (8,557)
Loss on disposition of property, plant and equipment	(5,323)	(99)
Others-net	(9,985)	647
Total	¥ (224,848)	¥ (8,009)

Additional retirement benefits relate early retirements of employees incurred as discussed in Note 10.

Loss on disposition of property, plant and equipment of ¥5,323 million for the year ended March 31, 2005, was recorded as a result of the reduction of the useful lives to the remaining period of use and intention of future disposition of certain tobacco manufacturing factories and other tobacco operation facilities which ceased their operations by March 31, 2005.

For the year ended March 31, 2006, "Others-net" in the Business restructuring costs includes the reversal of payables recognized due to the acceleration of planned retirement dates for employees on long-term leave who accepted the early retirement program implemented during the year ended March 31, 2005.

(3) Loss on impairment of long-lived assets

Asset grouping is based on the smallest identifiable unit that generates cash flows that are largely independent of the cash flows from other assets, except for idle property, which is grouped individually.

The Group reviewed its long-lived assets for impairment during the year ended March 31, 2006 and, as a result, recognized an impairment loss of ¥11,439 million, which principally consists of ¥7,738 million of land and ¥3,452 million of buildings and structures, as other expense mainly for company housing due to be discontinued which are mostly located in the Tokyo metropolitan area. During the second half of the year ended March 31, 2006, land and buildings of company housing were finally assessed to be discontinued, resulting in the change of asset groups for impairment testing. Most of the impairment losses were recognized on company housing after they were evaluated individually as a result

of the asset group change.

During the fiscal year ended March 31, 2007, the group recorded impairment losses of ¥2,712 million ($23 million), which relates principally to land, and certain buildings and structures which are planned to be demolished.

The recoverable amounts of these assets were measured at their net realizable value determined mainly by real estate appraised values.

(4) Other – net

"Other – net" included in "Other Income (Expenses)" for the years ended March 31, 2005, 2006 and 2007 consisted of the following:

	Millions of yen			Millions of U.S. dollars
	2005	2006	2007	2007
Financial support for domestic tobacco growers (see Note 14)	¥ (1,099)	¥ (863)	¥ (3,505)	$ (30)
Foreign exchange gain (loss)-net	1,026	(2,893)	(14,465)	(123)
Write-down of investment securities	(362)	(11)	—	—
Gain on sales of investment securities-net	1,112	879	1,908	16
Loss on partial termination of defined benefit plan (see Note 10)	—	(3,097)	—	—
Gain on disposition of marketing rights	2,533	—	—	—
One-time termination payment to domestic leaf tobacco growers	(4,228)	—	—	—
Introduction costs for vending machines with adult identification functions	—	(159)	(5,746)	(49)
Others-net	(1,617)	(3,376)	(9,390)	(78)
Total	¥ (2,635)	¥ (9,520)	¥ (31,198)	$ (264)

At the Leaf Tobacco Deliberative Council meeting in August 2004, JT inquired about soliciting farm families that met certain qualifications with respect to planting area sizes and farmers' ages to quit farming and it was approved by the council. As a result, JT paid ¥4,228 million to those tobacco growers who decided to quit farming in signing of farming contracts for the 2005 crop of leaf tobacco.

"Introduction costs for vending machines with adult identification functions" is the cost to establish the system of vending machines with functions to prevent minors from purchasing cigarettes from vending machines and to dispense cigarettes only after scanning and verifying special IC cards that indicate whether the purchaser is an adult or not.

16. Segment Information

The Company's business is divided into the domestic tobacco, international tobacco, pharmaceutical, foods and other industry segments. The domestic tobacco segment consists of manufacturing and sale of tobacco products, primarily cigarettes, in Japan, including tobacco products sold at duty free shops in Japan, as well as at markets in China, Hong Kong and Macau, which are covered by the China Division. The domestic tobacco segment includes the sales by TS Network, JT's subsidiary. TS Network distributes the tobacco products and conducts wholesale etc. of foreign brand tobacco products purchased from foreign tobacco manufacturers through importers. The international tobacco segment consists of manufacturing and sale of cigarettes in other markets worldwide not covered by the domestic tobacco segment. The pharmaceutical segment is concerned with the development, manufacturing and sale of prescription drugs. The foods segment involves manufacturing and sale of beverages and processed foods. Other segments include the real estate business, engineering business and other operations.

With respect to the international tobacco business, the accounting period of consolidated overseas subsidiaries, mainly represented by JTISA, ends December 31, 2006 and the results for the twelve months ended December 31, 2006 are consolidated for the year ended March 31, 2007.

(1) Industry segments

Information about the industry segments of the Company for the years ended March 31, 2005, 2006 and 2007 were as follows:

	Millions of yen							
	2005							
	Domestic Tobacco	International Tobacco	Pharmaceuticals	Foods	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	¥ 3,491,488	¥ 792,705	¥ 57,676	¥ 265,380	¥ 57,265	¥ 4,664,514	¥ —	¥ 4,664,514
Intersegment sales	49,550	54,933	—	203	30,440	135,126	(135,126)	—
Total sales	3,541,038	847,638	57,676	265,583	87,705	4,799,640	(135,126)	4,664,514
Operating expenses	3,325,205	803,180	55,821	263,635	77,278	4,525,119	(133,976)	4,391,143
Operating income	¥ 215,833	¥ 44,458	¥ 1,855	¥ 1,948	¥ 10,427	¥ 274,521	¥ (1,150)	¥ 273,371
Assets	¥ 1,298,222	¥ 838,590	¥ 117,828	¥ 141,647	¥ 197,050	¥ 2,593,337	¥ 388,719	¥ 2,982,056
Depreciation and amortization other than goodwill	80,219	21,004	3,619	5,150	16,313	126,305	(443)	125,862
Amortization of goodwill (negative goodwill)	(21)	—	—	833	70	882	—	882
Capital expenditures	46,485	18,787	3,108	7,356	10,629	86,365	(1,256)	85,109

	Millions of yen							
	2006							
	Domestic Tobacco	International Tobacco	Pharmaceuticals	Foods	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	¥ 3,405,281	¥ 881,188	¥ 49,257	¥ 278,378	¥ 23,553	¥ 4,637,657	¥ —	¥ 4,637,657
Intersegment sales	41,554	36,914	—	123	25,212	103,803	(103,803)	—
Total sales	3,446,835	918,102	49,257	278,501	48,765	4,741,460	(103,803)	4,637,657
Operating expenses	3,226,740	847,071	54,314	272,176	40,092	4,440,393	(109,682)	4,330,711
Operating income (loss)	¥ 220,095	¥ 71,031	¥ (5,057)	¥ 6,325	¥ 8,673	¥ 301,067	¥ 5,879	¥ 306,946
Assets	¥ 1,131,751	¥ 994,834	¥ 117,903	¥ 141,477	¥ 194,401	¥ 2,580,366	¥ 457,013	¥ 3,037,379
Depreciation and amortization other than goodwill	84,570	23,062	3,254	5,042	13,467	129,395	(4,540)	124,855
Impairment Loss	991	184	—	70	—	1,245	10,194	11,439
Amortization of goodwill	1,088	—	—	502	—	1,590	—	1,590
Capital expenditures	75,028	24,995	2,107	4,576	19,318	126,024	(27,097)	98,927

	Millions of yen							
	2007							
	Domestic Tobacco	International Tobacco	Pharmaceuticals	Foods	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	¥ 3,416,274	¥ 999,658	¥ 45,452	¥ 286,554	¥ 21,449	¥ 4,769,387	¥ —	¥ 4,769,387
Intersegment sales	45,005	26,355	—	110	25,876	97,346	(97,346)	—
Total sales	3,461,279	1,026,013	45,452	286,664	47,325	4,866,733	(97,346)	4,769,387
Operating expenses	3,215,891	944,928	56,659	279,959	37,994	4,535,431	(98,035)	4,437,396
Operating income (loss)	¥ 245,388	¥ 81,085	¥ (11,207)	¥ 6,705	¥ 9,331	¥ 331,302	¥ 689	¥ 331,991
Assets	¥ 1,180,395	¥ 1,275,045	¥ 106,165	¥ 158,818	¥ 249,604	¥ 2,970,027	¥ 394,636	¥ 3,364,663
Depreciation and amortization other than goodwill	79,965	31,583	3,010	3,894	12,254	130,706	(600)	130,106
Impairment Loss	710	112	—	44	—	866	1,846	2,712
Amortization of goodwill	1,118	—	—	1,419	—	2,537	—	2,537
Capital expenditures	55,243	32,017	3,046	4,866	8,054	103,226	(1,079)	102,147

	Millions of U.S. dollars							
	2007							
	Domestic Tobacco	International Tobacco	Pharmaceuticals	Foods	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	$ 28,939	$ 8,468	$ 385	$ 2,427	$ 182	$ 40,401	$ —	$ 40,401
Intersegment sales	381	223	—	1	219	824	(824)	—
Total sales	29,320	8,691	385	2,428	401	41,225	(824)	40,401
Operating expenses	27,242	8,004	480	2,371	322	38,419	(830)	37,589
Operating income (loss)	$ 2,078	$ 687	$ (95)	$ 57	$ 79	$ 2,806	$ 6	$ 2,812
Assets	$ 9,999	$ 10,801	$ 899	$ 1,345	$ 2,115	$ 25,159	$ 3,343	$ 28,502
Depreciation and amortization other than goodwill	677	268	25	33	104	1,107	(5)	1,102
Impairment Loss	6	1	—	0	—	7	16	23
Amortization of goodwill	9	—	—	12	—	21	—	21
Capital expenditures	468	271	26	41	68	874	(9)	865

Operating expenses represent the aggregate amount of the cost of sales and selling, general and administrative expenses. Capital expenditures include long-term prepaid expenses and expensed amounts of the long-term prepaid expenses are included in depreciation and amortization other than goodwill.

Effective the year ended March 31, 2006, a part of goodwill recognized by foreign consolidated subsidiaries, represented by JTISA, was included in the Domestic Tobacco segment. Such change was to reflect the fact that JT, during the period ended March 31, 2006, started the import, manufacturing and sales of foreign consolidated subsidiaries' products for the Japanese market. Intersegment goodwill acquisition by the Company was included in capital expenditures of the Domestic Tobacco segment, and is eliminated in Elimination/Corporate.

The domestic tobacco segment includes the sales by TS Network. Net sales of such imported tobacco products via TS Network for the year ended March 31, 2005, 2006 and 2007 were ¥947,522 million, ¥1,160,744 million and ¥1,216,249 million ($10,303 million), respectively.

(2) Geographical segments

The geographical segments of the Company for the years ended March 31, 2005, 2006 and 2007 were summarized as follows:

	Millions of yen					
	2005					
	Japan	Western Europe	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	¥ 3,823,102	¥ 317,273	¥ 524,139	¥ 4,664,514	¥ —	¥ 4,664,514
Intersegment sales	54,785	137,406	14,563	206,754	(206,754)	—
Total sales	3,877,887	454,679	538,702	4,871,268	(206,754)	4,664,514
Operating expenses	3,649,540	458,052	490,006	4,597,598	(206,455)	4,391,143
Operating income (loss)	¥ 228,347	¥ (3,373)	¥ 48,696	¥ 273,670	¥ (299)	¥ 273,371
Assets	¥ 1,630,225	¥ 664,106	¥ 211,362	¥ 2,505,693	¥ 476,363	¥ 2,982,056

	Millions of yen					
	2006					
	Japan	Western Europe	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	¥ 3,709,964	¥ 338,606	¥ 589,087	¥ 4,637,657	¥ —	¥ 4,637,657
Intersegment sales	42,368	153,514	18,943	214,825	(214,825)	—
Total sales	3,752,332	492,120	608,030	4,852,482	(214,825)	4,637,657
Operating expenses	3,524,195	492,967	535,165	4,552,327	(221,616)	4,330,711
Operating income (loss)	¥ 228,137	¥ (847)	¥ 72,865	¥ 300,155	¥ 6,791	¥ 306,946
Assets	¥ 1,446,958	¥ 760,456	¥ 276,327	¥ 2,483,741	¥ 553,638	¥ 3,037,379

	Millions of yen					
	2007					
	Japan	Western Europe	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	¥ 3,718,450	¥ 353,831	¥ 697,106	¥ 4,769,387	¥ —	¥ 4,769,387
Intersegment sales	47,350	156,414	23,331	227,095	(227,095)	—
Total sales	3,765,800	510,245	720,437	4,996,482	(227,095)	4,769,387
Operating expenses	3,517,318	529,055	618,885	4,665,258	(227,862)	4,437,396
Operating income (loss)	¥ 248,482	¥ (18,810)	¥ 101,552	¥ 331,224	¥ 767	¥ 331,991
Assets	¥ 1,487,678	¥ 1,023,183	¥ 304,630	¥ 2,815,491	¥ 549,172	¥ 3,364,663

	Millions of U.S. dollars					
	2007					
	Japan	Western Europe	Others	Total	Elimination/ Corporate	Consolidated
Sales to customers	$ 31,499	$ 2,997	$ 5,905	$ 40,401	$ —	$ 40,401
Intersegment sales	401	1,325	198	1,924	(1,924)	—
Total sales	31,900	4,322	6,103	42,325	(1,924)	40,401
Operating expenses	29,795	4,481	5,243	39,519	(1,930)	37,589
Operating income (loss)	$ 2,105	$ (159)	$ 860	$ 2,806	$ 6	$ 2,812
Assets	$ 12,602	$ 8,667	$ 2,581	$ 23,850	$ 4,652	$ 28,502

"Western Europe" includes Switzerland, France and Germany while "Others" includes Canada, Russia and Malaysia. Operating expenses represent the aggregate amount of the cost of sales and selling, general and administrative expenses.

(3) Sales to foreign customers

Sales to foreign customers for the years ended March 31, 2005, 2006 and 2007 amounted to ¥855,658 million, ¥935,198 million and ¥1,056,762 million ($8,952 million), respectively.

17. Derivatives

JT and certain consolidated subsidiaries use derivative financial instruments ("derivatives"), including foreign currency forward contracts, currency options and currency swaps to hedge foreign exchange risk associated with certain assets and liabilities denominated in foreign currencies. JT and certain consolidated subsidiaries also entered into interest rate swaps as a means of managing their interest rate exposure.

Derivatives are subject to market risk and credit risk. Market risk is the exposure created by potential fluctuations in market conditions, including interest or foreign exchange rates. Credit risk is the possibility that a loss may result from a counterparty's failure to perform according to the terms and conditions of the contract. JT and these consolidated subsidiaries do not hold or issue derivatives for trading purposes. The main objective of using derivatives is to hedge the Company's exposure to interest rate risks associated with certain future interest receipts on debt securities, certain interest payments on borrowings and bonds and forecasted foreign currency denominated transactions.

The effectiveness of the hedging instruments is assessed in accordance with the Risk Management Policy and Practice Manual for financial instruments of JT and these consolidated subsidiaries by comparing the accumulated amount of changes in hedging instruments with hedged items. Hedging instruments and hedged items are summarized as follows:

Hedging instruments	Hedged items
Foreign currency forward contracts	Forecasted foreign currency transactions
Currency options	Forecasted foreign currency transactions
Interest rate swaps	Borrowings

Because the counterparties to such derivatives are limited to major international financial institutions, the Company does not anticipate any losses arising from credit risk.

The Company had the following derivatives contracts that do not qualify for hedge accounting and are outstanding at March 31, 2005, 2006 and 2007:

	Millions of yen								
	2005			2006			2007		
	Contract/ Notional Amount	Fair Value	Gain (Loss)	Contract/ Notional Amount	Fair Value	Gain (Loss)	Contract/ Notional Amount	Fair Value	Gain (Loss)
Foreign currency forward contracts:									
Buying	¥ 21,543	¥ 23,296	¥ 1,753	¥ 12,621	¥ 12,330	¥ (291)	¥ 2,972	¥ 3,113	¥ 141
Selling	12,048	12,116	(68)	43,234	43,663	(429)	40,624	40,839	(215)
Currency options:									
Buying	—	—	—	24,201	212	212	—	—	—
Selling	—	—	—	—	—	—	2,615	(318)	(318)
Total			¥ 1,685			¥ (508)			¥ (392)

	Millions of U.S. dollars		
	2007		
	Contract/ Notional Amount	Fair Value	Gain (Loss)
Foreign currency forward contracts:			
Buying	$ 25	$ 26	$ 1
Selling	344	346	(2)
Currency options:			
Buying	—	—	—
Selling	22	(3)	(3)
Total			$ (4)

The contract or notional amounts of derivatives which are shown in the above table do not represent the amounts exchanged by the parties and do not measure the Company's exposure to credit or market risks.

18. Net Income Per Share

Net income per share and weighted-average number of common shares outstanding retroactively adjusted for stock split, for the years ended March 31, 2005 and 2006 are as follows:

	Yen	
Years ended March 31,	2005	2006
Net income per share	¥ 6,418	¥ 21,017
The weighted-average number of common shares outstanding	9,714,505	9,580,080

Note: There's no disclosure for the diluted net income per share, as no such potentially dilutive securities exist.

19. Subsequent Event

On April 18, 2007, JT acquired 100% of the issued shares of Gallaher Group Plc ("Gallaher") located in UK, through JTI (UK) MANAGEMENT LTD, a wholly owned subsidiary of JT, by way of a Scheme of Arrangement under the Company Act in UK. The business combination will be accounted for by the purchase method, where JT is the acquiring company and Gallaher is the acquired company. Accordingly, Gallaher became a wholly owned subsidiary of JT.

1. The Details of Business Combination

(1) The following information provides the name of the acquired company, business content, main reasons for business combination, the date of business combination, the legal form of the business combination, and ratio of voting rights acquired.
  (a) The name of acquired company: Gallaher Group Plc
  (b) Business contents: Manufacture and sale of tobacco products
  (c) Main reasons for business combination:
    Through the acquisition of the Gallaher, JT could expand its business and enjoy the economy of scale, build well-balanced and competitive brand portfolio in each market and price segmentation, strengthen technology/distribution infrastructures, and synergize business growth expected of the business combination with effective business operations.
  (d) Date of business combination: April 18, 2007
  (e) Legal form of the business combination:
    The issued shares were acquired for cash.
  (f) Ratio of voting rights acquired: 100%

(2) Acquisition costs: Approximately 7.5 billion pounds
  (Approximately ¥1,720.0 billion, a part of which is financed by foreign-currency-denominated loans translated at the rate of £1 into ¥238.51)

(3) Amounts of goodwill and assets/liabilities assumed at the date of business combination:
  Identification and fair-value measurements of assets/liabilities assumed at the date of business combination are in process, therefore, amounts of goodwill and assets/liabilities assumed at the date of business combination are unconfirmed at this time.

(4) Others
  Summary of the balance sheet of the Gallaher as of December 31, 2006, based on the IFRS (International Financial Reporting Standards) is as follows;

	(Millions of sterling pounds)	(Billions of yen)
Current assets	1,525	356.3
Non-current assets	2,408	562.6
Current liabilities	1,457	340.4
Non-current liabilities	2,124	496.2
Net assets	352	82.3

The translation of GBP amounts into Japanese yen is made at the rate of £1 into ¥233.66.

Please note that the amount of assets/liabilities above indicates the business scale of the acquired company as references, and the figures do not indicate the exact amount of assets/liabilities assumed as of the date of the business combination.

2. The Details of Raising Funds

JT and JTI (UK) MANAGEMENT LTD concluded and executed the following loan agreement for the purpose of raising funds to acquire the issued shares of Gallaher.

(1) Borrowing by JT
  (a) Lender: Mizuho Bank Ltd.
  (b) Borrowing Amount: JPY 450.0 billion
  (c) Repayment: Bullet
  (d) Interest Rate: 0.80000% and 0.84000%
  (e) Borrowing Date: April 25, 2007
  (f) Term: 1 month and 3 months
  Of the above amount, JPY 100.0 billion was repaid on May 25, 2007. JT would execute to refinance the remaining amount of JPY 350.0 billion by means including borrowings and issuance of bonds. JT FINANCE SERVICE CO.,LTD., which controls the cash management system of JT group and is a wholly owned subsidiary of JT, signed an agreement of commitment line with financial institutions to meet the requirement of funds (short-term bank loans and repayment of the loans).

(2) Borrowing by JTI (UK) MANAGEMENT LTD
  (a) Lender: 18 syndicated banks, Merrill Lynch International and Merrill Lynch Japan Securities Co., Ltd. being Arrangers and The Bank of Tokyo-Mitsubishi UFJ, Ltd. being Agent Bank
  (b) Borrowing Amount: GBP 1.9 billion (Approximately ¥451.6 billion at the rate of £1 into ¥237.69)
  (c) Repayment: Bullet
  (d) Interest Rate: 5.76908%
  (e) Borrowing Date: April 26, 2007
  (f) Term: 2 months
  JTI (UK) Management LTD. and other JT group entities concluded a committed credit facility with syndicated banks for the purpose of refinancing the above loan of GBP 1.9 billion and would repay the above loan of GBP 1.9 billion by utilizing the committed credit facility.

Independent Auditors' Report

Deloitte.

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To the Board of Directors of
Japan Tobacco Inc.:

We have audited the accompanying consolidated balance sheets of Japan Tobacco Inc. ("JT") and consolidated subsidiaries (the "Company") as of March 31, 2006 and 2007, and the related consolidated statements of income, changes in equity, and cash flows for each of the three years in the period ended March 31, 2007, all expressed in Japanese yen. These consolidated financial statements are the responsibility of the Company's management. 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 Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of March 31, 2006 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended March 31, 2007, in conformity with accounting principles generally accepted in Japan.

As discussed in Note 14 to the consolidated financial statements, JTI-Macdonald Corp. ("JTI-MC"), JT's Canadian subsidiary, received a Notice of Assessment from the Quebec Ministry of Revenue on August 11, 2004, demanding payment of approximately Canadian dollar 1.36 billion (approximately ¥114.6 billion). JTI-MC filed an application of "Companies' Creditors Arrangement Act ("CCAA") to the Ontario Superior Court of Justice on August 24, 2004, and the filing of CCAA makes it possible for JTI-MC to continue business operations with its assets safeguarded.

As discussed in Note 19 to the consolidated financial statements, on April 18, 2007, the Company completed the acquisition of Gallaher Group plc by way of a Scheme of Arrangement pursuant to the Company Act in UK .

Our audits also comprehended the translation of Japanese yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 2. Such U.S. dollar amounts are presented solely for the convenience of readers outside Japan.

Tokyo, Japan
June 22, 2007