[This is an English translation prepared for the convenience of non-resident shareholders. Should there be any inconsistency between the translation and the official Japanese text, the latter shall prevail.]

March 1, 2017

To Our Shareholders

MATERIALS DISCLOSED VIA THE INTERNET CONCERNING NOTICE OF CONVOCATION OF THE 32ND ANNUAL SHAREHOLDERS' MEETING

"Notes to Consolidated Financial Statements" and "Notes to Nonconsolidated Financial Statements" are posted on the Company's website (https://www.jti.co.jp/) to be offered to shareholders, pursuant to the provisions of laws and regulations as well as Article 17 of our Articles of Incorporation.

Notes to Consolidated Financial Statements

Notes to Nonconsolidated Financial Statements

(For the fiscal year from January 1, 2016 to December 31, 2016)

Japan Tobacco Inc.

Notes to Consolidated Financial Statements

1. Significant matters for preparing consolidated financial statements

(1) Accounting principles for preparing consolidated financial statements

The consolidated financial statements of Japan Tobacco Inc. (hereinafter referred to as the “Company”) and its subsidiaries (hereinafter collectively referred to as the “Group”) are prepared in accordance with International Financial Reporting Standards (hereinafter referred to as “IFRS”) pursuant to the provisions of Article 120, Paragraph 1 of the Ordinance on Accounting of Companies. Pursuant to the provisions of the second sentence of the same paragraph of the same Ordinance, some disclosure items required under IFRS are omitted.

(2) Early adoption of new standards

The Group has early adopted IFRS 9 “Financial Instruments” (amended in November 2013) (hereinafter referred to as “IFRS 9”) from January 1, 2015.

IFRS 9 replaces IAS 39 “Financial Instruments: Recognition and Measurement” (hereinafter referred to as “IAS 39”) and provides two measurement categories for financial instruments: amortized cost and fair value. Changes in fair value of financial assets measured at fair value are recognized in profit or loss. However, changes in fair value of investments in equity instruments, except for equity instruments held for trading purposes, are allowed to be recognized in other comprehensive income.

For hedge accounting, the hedging relationships that meet the qualifying criteria are reviewed to appropriately reflect an entity’s risk management activities in the consolidated financial statements.

(3) Scope of consolidation

Number of consolidated subsidiaries: 202 companies

Major consolidated subsidiaries: TS Network Co., Ltd., Japan Filter Technology, Ltd., JT International S.A., Gallaher Ltd., Torii Pharmaceutical Co., Ltd., and TableMark Co., Ltd.

(4) Scope of equity method

Number of affiliates accounted for using the equity method: 12 companies

Major affiliates accounted for using the equity method: Megapolis Distribution B.V.

Joint ventures are accounted for using the equity method.

(5) Accounting policies

A. Basis and method of valuation for financial assets other than derivatives

i) Initial recognition and measurement

Financial assets are classified into financial assets measured at fair value through profit or loss, fair value through other comprehensive income, and amortized cost. The Group determines the classification at initial recognition.

Financial assets are classified as financial assets measured at amortized cost if both of the following conditions are met. Otherwise, they are classified as financial assets measured at fair value.

- The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

For financial assets measured at fair value, each equity instrument is designated as measured at fair value through profit or loss or as measured at fair value through other comprehensive income, except for equity instruments held for trading purposes that must be measured at fair value through profit or loss. Such designations are applied consistently.

All financial assets are measured at fair value plus transaction costs that are attributable to the financial assets, except for the case of being classified in the category of financial assets measured at fair value through profit or loss.

ii) Subsequent measurement

After initial recognition, financial assets are measured based on the classification as follows:

(a) Financial assets measured at amortized cost

Financial assets measured at amortized cost are measured at amortized cost using the effective interest method.

(b) Other financial assets

Financial assets other than those measured at amortized cost are measured at fair value.

Changes in the fair value of financial assets measured at fair value are recognized as profit or loss.

However, changes in the fair value of equity instruments designated as measured at fair value through other comprehensive income are recognized as other comprehensive income and the amount in other comprehensive income is transferred to retained earnings when equity instruments are derecognized or the decline in its fair value compared to its acquisition cost is significant. Dividends on the financial assets are recognized in profit or loss for the year.

iii) Derecognition

Financial assets are derecognized when the rights to receive benefits from them expire or are transferred, or when substantially all the risks and rewards of the ownership are transferred.

iv) Impairment of financial assets

In accordance with IAS 39, the Group assesses at the end of each reporting period whether there is any objective evidence that financial assets measured at amortized cost are impaired. Evidence of impairment includes significant financial difficulty of the borrower or a group of borrowers, a default or delinquency in interest or principal payments, and bankruptcy of the borrower.

The Group assesses whether objective evidence of impairment exists individually for financial assets that are individually significant and collectively for financial assets that are not individually significant.

If there is objective evidence that impairment losses on financial assets measured at amortized cost have been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows.

When impairment is recognized, the carrying amount of the financial asset is reduced by an allowance for doubtful accounts and impairment losses are recognized in profit or loss. The carrying amount of financial assets measured at amortized cost is directly reduced for the impairment when they are expected to become uncollectible in the future and all collaterals are implemented or transferred to the Group. If, in a subsequent period, the amount of the impairment loss provided changes due to an event occurring after the impairment was recognized, the previously recognized impairment losses are adjusted through the allowance for doubtful accounts.

B. Basis and method of valuation for derivatives

The Group utilizes derivatives, including forward foreign exchange contracts and interest rate swap contracts, to hedge foreign exchange and interest rate risks. These derivatives are initially measured at fair value when the contract is entered into, and are subsequently remeasured at fair value. Changes in the fair value of derivatives are recognized as profit or loss in the consolidated statement of income. However, the gains or losses on the hedging instrument relating to the effective portion of cash flow hedges and hedges of net investment in foreign operations are recognized as other comprehensive income.

C. Basis and method of valuation for inventories

The cost of inventories includes all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
Inventories are measured at the lower of cost or net realizable value, and the costs are determined by using the weighted-average method. Net realizable value is determined as the estimated selling price in the ordinary course of business less the estimated costs of completion and estimated costs necessary to make the sale.
Leaf tobacco which is stored for more than 12 months before being used for production is included in current assets since it is held within the normal operating cycle.

D. Depreciation methods for significant depreciable assets

i) Property, plant and equipment and investment property (excluding leased assets)
Property, plant and equipment is measured by using the cost model and is stated at cost less accumulated depreciation and accumulated impairment losses.
The acquisition cost includes any costs directly attributable to the acquisition of the asset and dismantlement, removal and restoration costs, as well as borrowing costs eligible for capitalization.
Except for assets that are not subject to depreciation such as land, assets are depreciated using the straight-line method over their estimated useful lives.
Investment property is property held to earn rentals or for capital appreciation or both.
Investment property is measured by using the cost model and is stated at cost less accumulated depreciation and accumulated impairment losses.
The estimated useful lives of major asset items are as follows:

- Buildings and structures: 38 to 50 years
- Machinery and vehicles: 10 to 15 years

The estimated useful lives and depreciation method are reviewed at each fiscal year end and if there are any changes made to the estimated useful lives and depreciation method, such changes are applied prospectively as changes in estimate.

ii) Intangible assets (excluding leased assets)
Intangible assets are measured by using the cost model and are stated at cost less accumulated amortization and accumulated impairment losses.
Intangible assets acquired separately are measured at cost at the initial recognition, and the costs of intangible assets acquired through business combinations are recognized at fair value at the acquisition date. Expenditures on internally generated intangible assets are recognized as expense in the period when incurred, except for development expenses that satisfy the capitalization criteria.
Intangible assets with finite useful lives are amortized using the straight-line method over their estimated useful lives and are tested for impairment whenever there is any indication of impairment. The estimated useful lives and amortization method of intangible assets with finite useful lives are reviewed at each fiscal year end, and the effect of any changes in estimate would be accounted for on a prospective basis.

The estimated useful lives of major intangible assets with finite useful lives are as follows:

- Trademarks: 10 to 20 years
- Software: 5 years

Intangible assets with indefinite useful lives and intangible assets that are not ready to use are not amortized, but they are tested for impairment individually or by cash-generating unit annually or whenever there is any indication of impairment.

iii) Leased assets

Leases are classified as finance leases whenever substantially all the risks and rewards incidental to ownership are transferred to the Group. All other leases are classified as operating leases.

In finance lease transactions, leased assets and lease obligations are recognized in the consolidated statement of financial position at the lower of the fair value of the leased property or the present value of the minimum lease payments, each determined at the inception of the lease. Lease payments are apportioned between the financial cost and the reduction of the lease obligations based on the effective interest method. Financial costs are recognized in the consolidated statement of income. Leased assets are depreciated using the straight-line method over their estimated useful lives or lease terms, whichever is shorter.

In operating lease transactions, lease payments are recognized as an expense using the straight-line method over the lease terms in the consolidated statement of income. Contingent rents are recognized as an expense in the period when they are incurred.

Determining whether an arrangement is, or contains, a lease is based on the substance of the arrangement in accordance with IFRIC 4 “Determining Whether an Arrangement Contains a Lease,” even if the arrangement does not take the legal form of a lease.

E. Policy on accounting of significant provisions

The Group has present obligations (legal or constructive) resulting from past events and recognizes provisions when it is probable that the obligations are required to be settled and the amount of the obligations can be estimated reliably.

Where the effect of the time value of money is material, the amount of provisions is measured at the present value of the expenditures expected to be required to settle the obligations. In calculating the present value, the Group uses the pretax discount rate reflecting current market assessments of the time value of money and the risks specific to the liability.

In accordance with IAS 37 “Provisions, Contingent Liabilities and Contingent Assets,” the Group recognizes a provision for restructuring when it has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main scheme to those affected by it. Restructuring provisions include only the direct expenditures arising from the restructuring, which meet both of the following criteria:

- necessarily entailed by the restructuring;
- not associated with the ongoing activities of the entity.

F. Post-employment benefits

The Group sponsors defined benefit plans and defined contribution plans as employee retirement benefit plans.

The Company is obligated to bear pension expenses for a mutual assistance association incurred with respect to services in or before June 1956 (prior to the enforcement of the Act on the Mutual Aid Association of Public Corporation Employees). Such obligations are calculated and included in liabilities related to the retirement benefits.

For each plan, the Group calculates the present value of defined benefit obligations, related current service cost and past service cost using the projected unit credit method. For a discount rate, a discount period is determined based on the period until the expected date of benefit payment in each fiscal year, and the discount rate is determined by reference to market yields for the period corresponding to the discount period at the end of the fiscal year on high quality corporate bonds or government bonds. Liabilities or assets for defined benefit plans are calculated by the present value of the defined benefit obligation, deducting the fair value of any plan assets (including adjustments for the asset ceiling for defined benefit plans and minimum funding requirements, if necessary). Expected interest costs and interest income are recognized as financial costs.

Remeasurements of defined benefit plans are recognized in full as other comprehensive income in the period when they are incurred and transferred to retained earnings immediately. Past service costs are recognized as profit or loss in the period when incurred.

The cost for retirement benefits for defined contribution plans is recognized as an expense at the time of contribution.

G. Accounting for revenue

i) Sale of goods

The Group mainly engages in the sale of tobacco products, prescription drugs, and processed foods. Revenue from the sale of these goods is recognized when the significant risks and rewards of ownership of the goods transfer to the buyers, the Group retains neither continuing managerial involvement nor effective control over the goods sold, it is probable that the future economic benefits will flow to the Group, and the amount of revenue and the corresponding costs can be measured reliably. Therefore, revenue is usually recognized at the time of delivery of goods to customers. In addition, revenue is recognized at fair value of the consideration received or receivable less discounts, rebates and taxes, including consumption taxes.

Since the amount of turnover where the Group is involved as an agency, including tobacco excise taxes, is deducted from revenue, the Group recognizes only the economic benefit inflow, excluding such amount as revenue in the consolidated statement of income.

ii) Interest income

Interest income is recognized using the effective interest rate method.

iii) Dividend income

Dividend income is recognized when the shareholder’s right to receive payment is established.

iv) Royalties

Royalties are recognized on an accrual basis in accordance with the substance of the relevant agreement.

H. Goodwill

Goodwill is stated at acquisition cost less accumulated impairment losses.

Goodwill is not amortized. It is allocated to cash-generating units that are identified according to locations and types of businesses and tested for impairment annually or whenever there is any indication of impairment. Impairment losses on goodwill are recognized in the consolidated statement of income and no subsequent reversal is made.

I. Method of foreign currency translation

Consolidated financial statements of the Group are presented in Japanese yen, which is the functional currency of the Company. Each company in the Group specifies its own functional currency and measures transactions based on it.

Foreign currency transactions are translated into the functional currency at the rates of exchange prevailing at the dates of transactions or an approximation of the rate. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rates of exchange prevailing at the fiscal year end date. Differences arising from the translation and settlement are recognized as profit or loss. However, exchange differences arising from the translation of financial instruments designated as hedging instruments for net investment in foreign operations (foreign subsidiaries), financial assets measured at fair value through other comprehensive income, and cash flow hedges are recognized as other comprehensive income.

The assets and liabilities of foreign operations are translated into Japanese yen at the rates of exchange prevailing at the fiscal year end date, while income and expenses of foreign operations are translated into

Japanese yen at the rates of exchange prevailing at the dates of transactions or an approximation to the rate. The resulting translation differences are recognized as other comprehensive income. In cases where foreign operations are disposed of, the cumulative amount of translation differences related to the foreign operations is recognized as profit or loss in the period of disposition.

J. Method of significant hedge accounting

The Group utilizes derivatives, including forward foreign exchange contracts and interest rate swap contracts, to hedge foreign exchange and interest rate risks. These derivatives are initially measured at fair value when the contract is entered into, and are subsequently remeasured at fair value. Changes in the fair value of derivatives are recognized as profit or loss in the consolidated statement of income. However, the gains or losses on the hedging instrument relating to the effective portion of cash flow hedges and hedges of net investment in foreign operations are recognized as other comprehensive income.

At the inception of the hedge, the Group formally designates and documents the hedging relationship to which hedge accounting is applied and the objectives and strategies of risk management for undertaking the hedge. The documentation includes identification of hedging instruments, the hedged items, the nature of the risks being hedged and how the hedging relationship's effectiveness is assessed. These hedges are assessed on an ongoing basis to determine whether the hedging relationship is effective prospectively, even though it is expected that there is an economic relationship between the hedged item and the hedging instrument, that the effect of credit risk does not dominate the value changes that result from that economic relationship, and that the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the Group actually hedges and the quantity of the hedging instrument that the Group actually uses to hedge that quantity of hedged item.

If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio due to changes in an economic relationship between the hedged item and the hedging instrument but the risk management objective remains the same, the Group would adjust the hedge ratio so that it meets the qualifying criteria again. The Group discontinues hedge accounting for the part that does not meet the requirement when the hedging relationship ceases to meet the qualifying criteria after adjusting the hedge ratio.

Hedges that meet the stringent requirements for hedge accounting are classified in the following categories and accounted for in accordance with IFRS 9.

i) Fair value hedge

The gain or loss on the hedging instrument is recognized as profit or loss in the consolidated statement of income. However, changes in the fair value of the hedging instrument are recognized as other comprehensive income if the hedging instrument hedges an equity instrument designated as at fair value through other comprehensive income. Regarding the hedging gain or loss on the hedged item, the carrying amount of the hedged item is adjusted and the change is recognized as profit or loss in the consolidated statement of income. However, changes in fair value of an equity instruments which the Group elected to present in other comprehensive income are recognized as other comprehensive income.

ii) Cash flow hedge

The effective portion of gains or losses on hedging instruments is recognized as other comprehensive income in the consolidated statement of comprehensive income, while the ineffective portion is recognized immediately as profit or loss in the consolidated statement of income.

The amounts of hedging instruments recognized in other comprehensive income are reclassified to profit or loss when the transactions of the hedged items affect profit or loss. In cases where hedged items result in the recognition of non-financial assets or liabilities, the amounts recognized as other comprehensive income are accounted for as adjustments to the original carrying amount of non-financial assets or liabilities.

If the hedged future cash flows are no longer expected to occur, any related cumulative gain or loss that has been recognized in equity as other comprehensive income is reclassified to profit or loss. If the hedged future cash flows are still expected to occur, amounts that have been recognized in other comprehensive income are continued to be recognized in other comprehensive income until the future cash flows occur.

iii) Hedge of net investment in foreign operations

Translation differences resulting from the hedge of net investment in foreign operations are accounted for similarly to a cash flow hedge. The effective portion of gains or losses on hedging instruments is recognized as other comprehensive income, while the ineffective portion is recognized as profit or loss in the consolidated statement of income. At the time of the disposal of the foreign operations, any related cumulative gain or loss that has been recognized in equity as other comprehensive income is reclassified to profit or loss.

K. National consumption tax and local consumption tax are excluded from the consolidated statement of income.

(6) Changes in accounting policies

From this fiscal year, the Group has adopted IAS 19 “Employee Benefits” (amended in September 2014).

The effect of adopting the above standards on the consolidated financial statements is immaterial.

2. Notes to consolidated statement of financial position

(1) Accumulated depreciation of assets (including accumulated impairment losses)

Property, plant and equipment:	¥849,053 million
Goodwill and intangible assets:	¥739,661 million
Investment property:	¥33,061 million

(2) Assets pledged as collateral and liabilities relating to collateral

i) Pursuant to Article 6 of the Japan Tobacco Inc. Act, the Company's properties are pledged as general collateral for its corporate bonds.

Amount of liabilities relating to collateral

Bonds:	¥358,158 million

ii) Assets pledged as collateral related to some consolidated subsidiaries are ¥66 million.

The amount of liabilities related to assets pledged as collateral is ¥53 million.

(3) Allowance for doubtful accounts directly deducted from assets

Trade and other receivables:	¥1,515 million
Other financial assets:	¥6,920 million

3. Notes to consolidated statement of changes in equity

(1) Class and total number of issued shares and class and total number of treasury shares

(Thousands of shares)

	Number of shares as of January 1, 2016	Increase for the year ended December 31, 2016	Decrease for the year ended December 31, 2016	Number of shares as of December 31, 2016
Issued shares				
Ordinary shares	2,000,000	–	–	2,000,000
Treasury shares				
Ordinary shares	209,285	0	241	209,044

(Notes) The increase of 0 thousand treasury shares is due to purchase of shares less than one unit. The decrease of 241 thousand treasury shares is composed of 241 thousand shares due to exercise of share option and 0 thousand shares due to sales of shares less than one unit.

(2) Cash dividends

i) Dividends payments

Resolution	Class of shares	Total dividends (Millions of yen)	Dividends per share (Yen)	Basis date	Effective date
Annual Shareholders' Meeting (March 23, 2016)	Ordinary shares	114,606	64	December 31, 2015	March 24, 2016
Board of Directors (August 1, 2016)	Ordinary shares	114,617	64	June 30, 2016	September 1, 2016

ii) Dividends whose basis date is in the year ended December 31, 2016 but whose effective date falls in the year ending December 31, 2017
The following proposal will be placed on the agenda of the Annual Shareholders' Meeting to be held on March 24, 2017.

(Proposal)	Class of shares	Total dividends (Millions of yen)	Source of dividends	Dividends per share (Yen)	Basis date	Effective date
Annual Shareholders' Meeting (March 24, 2017)	Ordinary shares	118,203	Retained earnings	66	December 31, 2016	March 27, 2017

(3) Class and number of shares under subscription rights to shares as of December 31, 2016 (excluding rights whose exercise period has not yet begun)

Ordinary shares 976,800 shares

4. Financial instruments

(1) Status of financial instruments

The Group is exposed to financial risks (credit risk, liquidity risk, foreign exchange risk, interest rate risk and market price fluctuation risk) in the process of its management activities, and it manages risks based on a specific policy in order to avoid or reduce said risks. The results of risk management are regularly reported by the Treasury Division to the president and the Board of Directors.

The Group policy limits derivatives to transactions for the purpose of mitigating risks from transactions based on actual demand. Therefore, we do not transact derivatives for speculation purposes or trading purposes.

(2) Fair value of financial instruments

The carrying amounts on the consolidated statement of financial position and the fair values as of December 31, 2016 are as follows:

(Millions of yen)

	Carrying amount on consolidated statement of financial position	Fair value
1) Long-term borrowings	1,449	1,449
2) Bonds	358,158	357,126

With regard to short-term financial assets and short-term financial liabilities measured at amortized cost, the fair value approximates the carrying amount.

The fair value of long-term borrowings is calculated based on the present value which is obtained by discounting the total of the principal and interest by the interest rate assumed in a case where the same loan is newly made.

The fair value of bonds issued by the Group is based on the market price for those having market prices, and based on the present value that is obtained by discounting the total of principal and interest by the interest rate, for which the remaining period and credit risk of such bonds are taken into consideration.

5. Investment property

(1) Status of investment property

The Group owns some rental properties such as office buildings in Tokyo Prefecture and other areas.

(2) Fair value of investment property

The carrying amount on the consolidated statement of financial position and the fair value of investment properties as of December 31, 2016 are as follows:

(Millions of yen)

	Carrying amount on consolidated statement of financial position	Fair value
Investment property	18,184	47,334

(Notes)
1. The carrying amount on the consolidated statement of financial position is the acquisition cost less accumulated depreciation and accumulated impairment losses, if any.
2. The fair value of investment properties is determined based on a valuation conducted by an external real estate appraiser. The valuation is made in accordance with the appraisal standards of the country where the investment property is located and based on market evidence of transaction prices for similar assets.

6. Per share information

(1)	Equity attributable to owners of the parent company per share:	¥1,371.39
(2)	Basic earnings per share:	¥235.47
(3)	Diluted earnings per share:	¥235.33

7. Contingencies

Contingent Liabilities

The Company and some of its subsidiaries are defendants in legal proceedings. Provisions are not accounted for in matters it is not practicable to reasonably estimate the final outcomes. The Company and some of its subsidiaries, who are defendants in such legal proceedings, believe that our defenses asserted in these proceedings are based on substantial evidence and implement the system for response to action with the assistance of external lawyers.

(1) Smoking and health related litigation

The Company and some of its subsidiaries become defendants in lawsuits filed by plaintiffs seeking damages for harm allegedly caused by smoking, the marketing of tobacco products, or exposure to tobacco smoke. As of December 31, 2016, there were a total of 20 smoking and health related cases pending in which one or more members of the Group were named as a defendant or for which the Company may have certain indemnity obligations pursuant to the agreement for the Company's acquisition of RJR Nabisco Inc.'s overseas (non-U.S.) tobacco operations.
The major ongoing smoking and health related cases are as follows:

i) Individual claim
There is one individual case brought against the Company's indemnitee in South Africa.

ii) Class actions
There are eight ongoing class actions in Canada against the Company's subsidiary and/or indemnitees.

iii) Health-care cost recovery litigation
There are ten ongoing health-care cost recovery cases in Canada pending against the Company's subsidiary and indemnitees brought by all the Canadian provinces (except three Canadian territories).

(2) Other legal proceedings

The Company and some of its subsidiaries are also engaged in other legal proceedings such as commercial and tax disputes, which may include proceedings that are conducted pursuant to applicable confidentiality obligations. Details of such proceedings and their outcomes are disclosed by the Company only where permitted by such confidentiality obligations. There is one main lawsuit that is pending in Japan with regard to claims for damages against some of the Company's subsidiaries.

8. Business Combinations

Acquisition of the Natural American Spirit Business outside the United States

(1) Summary of business combinations

On January 13, 2016, the Group acquired from the Reynolds American Inc. group ("RAI") the Natural American Spirit business outside the United States which included the non-U.S. trademarks and all outstanding shares of RAI's subsidiaries outside the U.S. which sold the brand, Santa Fe Natural Tobacco Company Japan K.K. (Note) and eight other subsidiaries.

Natural American Spirit, the tobacco brand that Santa Fe Natural Tobacco Company, Inc. launched in the U.S. in 1982, has established a unique brand positioning due to its additive-free tobacco products that abundantly use high quality leaf tobacco. The brand has steadily increased the sales volume in the U.S., Japan, Germany, Switzerland, Italy, Spain, the U.K. and others.

The purpose of this acquisition is that Natural American Spirit, which has a strong presence in a premium priced category, allows the Group to further extend its brand portfolio and strengthen the business foundation.

Notably in Japan, which accounts for the majority of the sales volume worldwide excluding the U.S., the brand has enjoyed broad support of consumers and experienced significant growth in sales volume. This acquisition is positioned as part of business investments to underpin the Group's sustainable long-term profit growth in Japan, which is one of the Group's most significant markets.

(Note) Santa Fe Natural Tobacco Company Japan K.K. changed its name to K.K. TRUE SPIRIT TOBACCO COMPANY on May 1, 2016.

(2) Financial impact on the Group

Since the acquisition date, the acquired business has contributed to total revenue and operating loss of ¥28,291 million and ¥13,946 million, respectively.

The amortization of trademarks acquired from the business combinations included in the above operating loss is ¥17,928 million.

(3) Consideration and details (Total of the acquisition)

The consideration is ¥591,420 million and all is paid in cash.

(4) Cash out for the business combinations (Total of the acquisition)

(Millions of yen)

	Net cash outflow for the business combinations
Cash consideration	591,420
Cash and cash equivalents in subsidiaries acquired	(4,335)
Net cash outflow for the business combinations	587,085

(5) Fair values of the assets acquired and liabilities assumed

(Millions of yen)

	Fair value
Current assets	21,369
Trademarks	180,471
Deferred tax assets	113,185
Other non-current assets	9,207
Total assets	324,232
Current liabilities	11,376
Non-current liabilities	8,415
Total liabilities	19,791
Goodwill	286,979

Goodwill represents future economic benefits for integration synergies including enhanced business scale in each market, and it is expected that most of the trademarks and goodwill are deductible for tax purposes.

Fair values of assets acquired and liabilities assumed are provisional amounts recognized at the acquisition date and may change during the measurement period (one year from the acquisition date).

Transaction costs of ¥293 million are expensed as incurred and recognized in “Selling, general and administrative expense.”

Other acquisitions

In addition to the above, the Group acquired other entities through business combinations for the year ended December 31, 2016, which are omitted as they are immaterial both individually and in aggregate.

9. All figures are rounded off to the nearest unit.

Notes to Nonconsolidated Financial Statements

1. Significant accounting policies

(1) Basis and method of valuation for securities

Shares of subsidiaries and affiliates:

Stated at cost determined by the moving-average method.

Available-for-sale securities:

Securities with a fair value:

Stated at fair value based on market prices on the closing date of the accounting period. (Valuation difference is stated as a component of net assets and the cost of securities sold is calculated by applying the moving-average method.)

Securities without a fair value:

Stated at cost determined by the moving-average method.

(2) Basis and method of valuation for derivatives

Stated based on the fair value method.

(3) Basis and method of valuation for inventories

Stated at cost determined by the average cost method.

(Balance sheet amounts are measured at the lower of cost or net selling value.)

(4) Depreciation methods for depreciable assets

i) Property, plant and equipment (excluding leased assets)

The declining-balance method is applied. However, the straight-line method is applied for buildings (excluding accompanying facilities) acquired on or after April 1, 1998 and for accompanying facilities and structures acquired on or after April 1, 2016.

The main useful lives are as follows:

Buildings (excluding accompanying facilities):	38 to 50 years
Machinery and equipment:	10 years

ii) Intangible assets (excluding leased assets)

Straight-line method

The main useful lives are as follows:

Patent right:	8 years
Right of trademark:	10 years
Software:	5 years
Goodwill	10 years

iii) Leased assets

For finance leases that do not transfer ownership of the leased property to the lessee, depreciation expense is mainly computed by the straight-line method over the lease period as the useful life assuming no residual value.

(5) Policy on accounting of provisions

i) Allowance for doubtful accounts

Provided for possible losses from bad debts at an amount determined based on the historical default rate for ordinary receivables and the individual recoverability of specific doubtful receivables from customers experiencing financial difficulties.

ii) Provision for bonuses

Provided based on the estimated payable amount to provide for the payment of bonuses to employees and directors.

iii) Provision for retirement benefits

Provided in preparation for the payment of retirement benefits to employees based on the estimated retirement benefit obligations and fair values of plan assets as of the end of this fiscal year. In calculating retirement benefit obligations, the benefit formula basis is used as the method of attributing expected benefit to periods up to the year ended December 31, 2016.

Past service cost is amortized using the straight-line method over the average remaining years of service of the employees (10 years).

Actuarial gains and losses are amortized from the year following the year in which the gains or losses are recognized using the straight-line method over the average remaining years of service of the employees (10 years).

Also included in the provision for retirement benefits is the portion of public pension expenses for mutual assistance association during certain periods in or before June 1956 (prior to the enforcement of the Act on the Mutual Aid Association of Public Corporation Employees).

(6) Policy on translation of assets and liabilities denominated in foreign currency into Japanese yen

Receivables and payables denominated in foreign currencies are translated into Japanese yen at the rates prevailing at the closing date of the accounting period with translation differences treated as gains or losses occurring in the corresponding fiscal year.

(7) Method of hedge accounting

Deferral hedge accounting is applied.

For interest rates and currency swaps, if they satisfy the requirements for treatment that incorporates swaps into underlying accounting items (accounting by applying foreign exchange rate stipulated in the contracts; exceptional treatment), they are accounted for by incorporating swaps into underlying accounting items.

(8) National consumption tax and local consumption tax are excluded from each amount of the nonconsolidated statement of income.

(9) Changes in accounting policies

(Application of Practical Solution on a change in depreciation method due to Tax Reform 2016)

Following the revision to the Corporation Tax Act, the “Practical Solution on a change in depreciation method due to Tax Reform 2016” (ASBJ Practical Issues Task Force No.32 of June 17, 2016) was applied from this fiscal year and the depreciation method for accompanying facilities with buildings and structures acquired on or after April 1, 2016 was changed from the declining-balance method to the straight-line method.
The impact of these changes on operating income, ordinary income and income before income tax is immaterial.

(Application of Revised Accounting Standard for Business Combinations)

From the beginning of this fiscal year, the Company has adopted the “Revised Accounting Standard for Business Combinations” (ASBJ Statement No.21 of September 13, 2013; the “Business Combinations Accounting Standard”) and the “Revised Accounting Standard for Business Divestitures” (ASBJ Statement No. 7 of September 13, 2013; the “Business Divestiture Accounting Standard”), etc., and the accounting method was changed to recognize the acquisition-related costs as expenses for the fiscal year in which they occurred. In addition, for business combinations that take place from the beginning of this fiscal year, the accounting method was changed to retroactively reflect adjustments to the amount allocated to acquisition cost under tentative accounting treatment on the nonconsolidated financial statements for the fiscal year in which the relevant business combinations became or will become effective.
In accordance with the transitional accounting treatment set forth in Article 58-2 (4) of the Business Combinations Accounting Standard and Article 57-4 (4) of the Business Divestiture Accounting Standard, these accounting standards have been prospectively applied from the beginning of this fiscal year.
The impact of these changes on operating income, ordinary income and income before income tax is immaterial.

(10) Changes in method of presentation

For the year ended December 31, 2015, “Business restructuring costs” was presented separately in “Extraordinary losses” in the nonconsolidated statement of income; however, for the year ended December 31, 2016, it is included in “Other” in “Extraordinary losses” due to its decreased materiality.

2. Notes to nonconsolidated balance sheet

(1) Receivables and payables with respect to subsidiaries and affiliates (excluding items separately presented)

Short-term receivables:	¥25,277 million
Short-term payables:	¥26,330 million
Long-term payables:	¥6,367 million

(2) Accumulated depreciation of property, plant and equipment: ¥468,267 million

(3) Pursuant to Article 6 of the Japan Tobacco Inc. Act, the Company’s assets are pledged as general collateral for its corporate bonds.

Amount of liabilities relating to collateral: Bonds ¥355,808 million

(4) Guarantee obligations

Guaranteed party	Guarantee amount	Type of guarantee obligation	
JT International Holding B.V.	(Millions of yen) 58,311	Loan guarantee, guarantee denominated in foreign currencies	¥58,311 million (USD 500 million) others
JT International Hellas A.E.B.E.	40,698	Loan guarantee, guarantee denominated in foreign currencies	¥40,698 million (EUR 333 million)
JT International S.A.	14,983	Loan guarantee, guarantee denominated in foreign currencies	¥14,983 million (USD 80 million) (EUR 37 million) (RUB 312 million) others
LLC Petro	11,304	Loan guarantee, guarantee denominated in foreign currencies	¥11,304 million (RUB 5,886 million)
Other (39 companies)	54,893	Loan guarantee	
Total	180,189		

(5) Payables to Directors and Audit & Supervisory Board Members

Long-term payables:	¥7 million

(6) "Cash management system deposits received" are funds entrusted in the cash management system for domestic group companies.

3. Notes to nonconsolidated statement of income

(1) Net sales including tobacco excise taxes for the year ended December 31, 2016 amounted to ¥1,955,218 million. Net sales including tobacco excise taxes are the amount of net sales plus the amount equivalent to tobacco excise taxes.

(2) Amount of transactions with subsidiaries and affiliates

Net sales:	¥89,831 million
Purchase of goods:	¥73,784 million
Selling, general and administrative expenses:	¥53,243 million
Dividends income:	¥5,445 million
Amount of non-operating transactions:	¥22,191 million

(3) Total research and development expenses are ¥47,783 million, all of which were recorded as general and administrative expenses.

4. Notes to nonconsolidated statement of changes in net assets

Class and number of shares of treasury shares

(Thousands of shares)

	Number of shares as of January 1, 2016	Increase for the year ended December 31, 2016	Decrease for the year ended December 31, 2016	Number of shares as of December 31, 2016
Treasury shares				
Ordinary shares	209,285	0	241	209,044
Total	209,285	0	241	209,044

(Note) The increase of 0 thousand treasury shares is due to purchase of shares less than one unit. The decrease of 241 thousand treasury shares is composed of 241 thousand shares due to exercise of share option and 0 thousand shares due to sales of shares less than one unit.

5. Tax effect accounting

(1) Breakdown of deferred tax assets and deferred tax liabilities by major cause

Deferred tax assets	
Provision for retirement benefits	¥23,534 million
Obligations pertaining to mutual assistance pension benefits	¥16,379 million
Accounts payable to employees who have agreed to early retirement	¥4,293 million
Other	¥23,999 million
Subtotal	¥68,205 million
Less valuation allowance	(¥11,136) million
Deferred tax assets total	¥57,070 million
Deferred tax liabilities	
Reserve for reduction entry	(¥19,109) million
Deferred gains or losses on hedges	(¥10,751) million
Valuation difference on available-for-sale securities	(¥10,290) million
Other	(¥8,890) million
Deferred tax liabilities total	(¥49,040) million
Net deferred tax assets	¥8,030 million

(2) Reconciliation between the effective statutory tax rate and the actual effective tax rate after applying tax effect accounting, if there is a significant difference

Note relating to the reconciliation between the effective statutory tax rate and the actual effective tax rate after applying tax effect accounting is omitted due to the fact that the difference is less than 5 percent of effective statutory tax rate.

(3) Adjustment of amounts of deferred tax assets and deferred tax liabilities due to changes in corporate tax rates

With the enactment of “Act for Partial Revision of the Income Tax Act and Other Acts” (Act No.15 of 2016) and “Act for Partial Revision of Local Taxation Act and Other Acts” (Act No.13 of 2016) on March 29, 2016 in the National Diet of Japan, corporate tax rates are reduced from fiscal years beginning on or after April 1, 2016. Accordingly, the effective statutory tax rate used for the calculation of deferred tax assets and deferred tax liabilities is changed from 32.01% to 30.66% for the temporary differences to be reversed in the fiscal year beginning on January 1, 2017 and to 30.43% for the temporary differences to be reversed in the fiscal years beginning on or after January 1, 2018.

As a consequence of this tax rate change, deferred tax assets (net of deferred tax liabilities) are decreased by ¥641 million, and income taxes–deferred, valuation difference on available-for-sale securities and deferred gains or losses on hedges are increased by ¥1,729 million, ¥534 million and ¥553 million, respectively.

6. Related-party transactions

Subsidiaries and Affiliates

Type	Name	Ownership ratio of voting rights	Relation with related-parties	Description of transaction	Transaction amount		Item	End-of-period balance
					Lending of funds	Receipt of repayment of funds		
					millions of yen	millions of yen		millions of yen
Subsidiary	Table Mark Holdings Co., Ltd.	Direct ownership 100%	Lending of funds	Lending of funds (Notes 1, 2)	42,024	44,996	Short-term loan receivables from subsidiaries and affiliates	44,035
							Long-term loan receivables from subsidiaries and affiliates	3,219

Type	Name	Ownership ratio of voting rights	Relation with related-parties	Description of transaction	Transaction amount	Item	End-of-period balance
					millions of yen		millions of yen
Subsidiary	TS Network Co., Ltd.	Direct ownership 74.5%	Deposits received for cash management system	Receipt of surplus funds (Notes 1, 2)	–	Cash management system deposits received	186,085
	JT International Hellas A.E.B.E.	Indirect ownership 100%	Guarantee of obligations	Guarantee of obligations (Note 3)	40,698	–	–
	JT International Holding B.V.	Indirect ownership 100%	Guarantee of obligations	Guarantee of obligations (Note 3)	58,311	–	–
	JT International Group Holding B.V.	Direct ownership 100%	–	Return of paid-in capital (Note 4)	185,907	–	–

Transaction conditions and policy on determination of transaction conditions

(Notes) 1. Interest rates on lending of funds and that on receipt of surplus funds are reasonably determined taking into account interest rates on the market.

2. For lending/borrowing from the cash management system, transaction amounts are omitted from the table above because of their frequent occurrence.

3. Guarantees of obligations are made for bank loans, and guarantee fees are calculated based on the guarantee amount.

4. JT International Group Holding B.V. reduced its paid-in capital and repaid $ 1,686 million.

7. Per share information

(1) Net assets per share:	¥927.93
(2) Net income per share:	¥96.94
(3) Diluted net income per share:	¥96.88

8. Significant subsequent events

Return of paid-in capital from a subsidiary

On January 11, 2017, the Company received approximately $0.5 billion (approximately ¥57.9 billion) return of paid-in capital from JT International Group Holding B.V. to repay a bank loan.

9. Business Combinations

Business Combinations through Acquisition

(1) Summary of business combinations

i) Acquired business

The Natural American Spirit business outside the United States from the Reynolds American Inc. group

ii) Major reason for the business combinations

The reason for this acquisition is that Natural American Spirit, which has a strong presence in a premium priced category, allows the Company to further extend its brand portfolio, strengthen the business foundation and underpin the Company's sustainable long-term profit growth.

iii) Date of business combinations

January 13, 2016

iv) Legal form of the business combinations

Transfer of business

v) Major reasons for the determination of the acquiring company

Transfer of business for consideration of cash

(2) Period of operating result of the acquired business included in the financial statements

From January 13, 2016 to December 31, 2016

(3) Acquisition costs of the acquired business and its breakdown

Cash consideration	¥520,159 million

(4) Amount, reason and amortization method and period of goodwill incurred

i) Amount	¥357,710 million

ii) Reason

Goodwill represents future economic benefits from integration synergies including enhanced business scale in the "Domestic Tobacco Business"

iii) Amortization method and period

Straight-line method over 10 years

(5) Assets acquired and liabilities assumed on the business combination date and their major breakdown

Trademark	¥162,449 million

10. All figures are rounded off to the nearest unit.