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## Investigation Report on Inappropriate Transaction

6 October 2023

Internal Investigation Committee

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## **1 Purpose and structure of the investigation**

### **(1) Overview of our organisation**

The company's organisation comprises a head office and several business offices. Each business office has several engineering divisions, each of which carries out work in a specialised engineering field.

### **(2) Background of the investigation**

A member of the engineering division of business office A consulted with the manager of business office A, who succeeded Employee X, about the fact that he could not confirm the subcontracted deliverables of an order to Company Y (placed based on a subcontracting request drafted by Employee X, his former supervisor) for the work of which he was in charge. The subcontracted deliverables submitted by Employee X as relating to Company Y were very similar to subcontracted deliverables from another company, so an investigation was initiated to clarify the facts and take the necessary action.

### **(3) Preliminary survey**

#### 1) Purpose of the survey

Following a report from business office A, a survey (preliminary survey) was initiated, led by the Governance Management Headquarters and the Administration Headquarters, with the following objectives.

- ascertaining the facts of the case
- investigating similar cases
- assessing the financial impact and implementing corrective action
- analysing the causes of the incident and exploring measures to prevent recurrence

#### 2) Investigation structure

The structure and responsibilities of the preliminary survey were as follows. No persons involved in the case were included. In addition, Mr. Go Ishikawa, Attorney at Law, was appointed as an adviser to provide legal advice on the case.

- Governance Management Headquarters (ascertaining the facts of the case)
- Administration Headquarters (investigating similar cases, assessing the financial impact and implementing corrective action, analysing the causes of the case and exploring measures to prevent recurrence)
- Information & Communication Technology Centre ('ICT Centre') (in charge of digital forensics)
- Advisor Go Ishikawa, Attorney at Law (Senior Partner, Sakurada Dori Sogo Law Office)
- Investigation assistant KPMG FAS Co., Ltd. (hereinafter referred to as 'KPMG') (digital forensic investigation)

#### 3) Survey period

19 May–3 August 2023

### **(4) Internal investigation committee**

#### 1) Investigation objectives

In accordance with Article 6 of the Compliance Regulations, an Internal Investigation Committee, chaired by the compliance officer, was established on 4 August 2023 for the following items.

- ascertaining the facts of the case
- investigating similar cases
- assessing the financial impact and implementing corrective action
- analysing the causes of the incident and exploring measures to prevent recurrence

#### 2) Investigation structure

Chairperson:

Yoshiaki Nanami, Chief, Governance Management Headquarters (compliance officer)

Committee members:

- Tatsuya Nishimura, Chief, Planning & Business Development Headquarters
- Naoto Suzuki, Chief, Administration Headquarters
- Go Ishikawa, Senior Partner, Sakurada Dori Sogo Law Office

Secretariat:

Compliance Office, Governance Management Headquarters

Research assistant:

KPMG (digital forensic investigation)

**(5) Investigation methods (including preliminary survey)**

1) Interviews with Employee X and other relevant persons within the company

- The company conducted interviews with Employee X, who carried out the subcontracting transactions in question, to confirm the facts and other information.
- The investigation was conducted by interviewing 15 persons, including those who approved subcontracting requests, those in charge of subcontracting management, and examiners and inspectors of subcontracting to Company Y, to confirm their roles at the time, the details of their duties, and their involvement in the case under investigation.

Interviews with Employee X

Item	Details
Party interviewed	Employee X
Investigation dates	25 July, 26 July, 28 July, 14 August, and 11 September 2023
Method of investigation	Interviews conducted in person
Investigators	Persons who are not involved in the subcontracting concerned, are familiar with the internal regulations, and are knowledgeable in legal matters
Investigation details	Fact-finding, motives, opportunities, parties involved, etc.

Interviews with internal stakeholders

Item	Details
Parties interviewed	Final approvers of the subcontracting request–approval process for subcontracting to Company Y (relating to documents drafted by Employee X), subcontracting management personnel, examiners, inspectors, general manager of the General Affairs Division, general manager of the Engineering Operations & Management Division (15 persons in total)
Investigation dates	27 July–3 August 2023
Method of investigation	Interviews conducted via Microsoft Teams or in person
Investigators	Persons who are not involved in the subcontracting concerned and are familiar with the internal regulations
Investigation details	<ul style="list-style-type: none"><li>- Role in the subcontracting request–approval procedure and the reasons for this role</li><li>- Actions taken in the subcontracting request–approval procedure</li><li>- Role of the general manager of the General Affairs Division (general manager only)</li><li>- Others (matters regarding Employee X, matters regarding Company Y, any other subcontracting irregularities, measures to prevent recurrence, etc.)</li></ul>

2) Digital forensic investigations

Due to the nature of the case, only Employee X was made a subject of the investigation. If, in the course of the investigation, suspicions of the involvement of others arose, said persons were to be added to the investigation targets. However, no such persons came to light.

Electronic media such as computers, emails, and USBs were preserved to the furthest extent possible. An investigation was conducted on the preserved data using search methods based on keywords related to illicit subcontracting transactions. The investigation was commissioned to KPMG, which has expertise in this area.

Item	Details
Parties subject to investigation	<ul style="list-style-type: none"> <li>- Only Employee X was made a subject of the investigation. If, in the course of the investigation, suspicions of the involvement of others arose, said persons were to be added to the investigation subjects.</li> <li>- No emails or other information requiring the addition of investigation subjects was found, and no persons suspected of being involved came to light.</li> </ul>
Media investigation	<ul style="list-style-type: none"> <li>- Computer (company-provided), mobile phone (company-provided), emails, chats</li> <li>- HDD (hard disk) and USB external media (shared by the division [company equipment]) identified as having been connected to the computer (Personal media cannot be connected to a company-provided computer.)</li> </ul>
Period subject to investigation	All periods during which there was data on the media subject to investigation
Search criteria (keyword settings)	- Determined based on the opportunity, motive, pressure, etc. pertaining to the case, in addition to keywords generally associated with illegal activity
Investigators	<ul style="list-style-type: none"> <li>- KPMG</li> <li>- ICT Centre, Legal Affairs Section</li> </ul>

### 3) Substantiation investigation into subcontracting transactions

Subcontracting-request approvals, specifications, and other supporting documents and subcontracted deliverables were checked.

Item	Details
Items subject to investigation	<ul style="list-style-type: none"> <li>- Subcontracting to Company Y relating to documents drafted by Employee X (42 cases)</li> <li>- Subcontracting to companies other than Company Y (20 companies) relating to documents drafted by Employee X (86 cases)</li> <li>- Expenses paid to Company Y (13 cases)</li> <li>- Expenses and purchasing transactions at the engineering division of business office A, other than those of Company Y, for which Employee X had approval authority at the time</li> </ul>
Investigators	- General manager of the General Affairs Division of the business office and a deputy chief (engineering) who has engineering expertise, neither of whom is involved in the case
Method of investigation	<ul style="list-style-type: none"> <li>- A person with the ability and objectivity (independence) to verify the relevant subcontracted deliverables (an employee belonging to [or who once belonged to] the engineering division or a person uninvolved in the relevant subcontracting request) checked the subcontracting request, the subcontracting specifications, and the subcontracted deliverables against each other and confirmed whether or not the subcontracted deliverables were present.</li> <li>- With regard to expenses and purchase transactions for which Employee X had approval authority in the engineering division of business office A, investigators checked whether there was an excessive increase in expenses and whether the results of several payments were extracted for deliverables.</li> </ul>

### 4) Investigations of external parties

Fact-finding checks were carried out with Company Y in relation to subcontracting relating to documents drafted by Employee X. In addition, interviews were conducted with seven subcontractors other than Company Y to ascertain whether or not there was any circumvention of subcontracting, etc.

Item	Details
Parties subject to investigation	Company Y and subcontractors other than Company Y relating to documents were drafted by Employee X in the last five years (seven companies)
Investigation period	26 July–9 August 2023
Method of investigation	Face-to-face, telephone, email
Investigators	Persons who are not involved in the subcontracting concerned, are familiar with the internal regulations, and are knowledgeable in legal matters
Items subject to investigation	Company Y: registration process, commission details, relationship with Employee X, etc. Subcontractors other than Company Y: registration history, subcontracting details, circumvention of subcontracting, uncontracted work, kickbacks or other requests, etc.

## 2 Facts of the case

The facts in this report are those accepted by the Commission's investigation as of 6 October 2023.

### (1) Overview of irregularities

The irregularities in question were inappropriate instances of subcontracting by Employee X, the former head of the engineering division of business office A, that totalled JPY 141,542,200 (including tax) and occurred from February 2008 to April 2023.

Employee X established Company Y in 2007 with an acquaintance as its representative director. From 2008 to 2023, by conspiring with a sales representative of Company Z who agreed to subcontract to Company Y again, Employee X continued to conduct transactions by which a portion of the subcontracting costs was returned to Company Y. Furthermore, in April 2009, Employee X became the head of a divisional office with the authority to make decisions on subcontracting and abused his decision-making authority to directly conduct transactions without substance between the Company and Company Y.

No other internal participants in the above two cases were identified.

### (2) How the irregularities were discovered

24 April 2023 A member of the engineering division of business office A consulted with the general manager of the engineering division of business office A, who succeeded Employee X, about the fact that the subcontracted deliverables of Company Y for work subcontracted to Company Y (relating to documents drafted by Employee X) for which he was responsible were not in the prescribed work folder and could not be verified.

25 April 2023 Upon receiving a report from the head of the engineering division of business office A, senior executive A of business office A ordered the entire engineering division to store the subcontracted deliverables on a designated business server, without the knowledge of Employee X, in order to confirm the truth of the matter. In response, the head of the engineering division issued instructions to all employees in the engineering division, and on the same day, Employee X submitted what he claimed to be two subcontracted deliverables relating to Company Y.

Mid-May 2023 When senior executive A of business office A checked the deliverables of the work subcontracted to Company Y submitted by Employee X, one was very similar to the deliverables of work subcontracted to other companies. Senior executive A of business office A instructed the head of the engineering division of business office A to check with the subcontractor whose subcontracted deliverables submitted by Employee X were very similar to those of Company Y, taking care not to inform Employee X, as to whether or not Company Y or the Company had provided data relating to the similar portions. The head of the engineering division of business

office A confirmed with the person in charge at the subcontractor in question that the subcontracted deliverables were all created by the subcontractor. Based on this, on 19 May, business office A requested the Governance Management Headquarters at the head office to conduct an investigation.

26 June 2023 Due to the possibility of evidence being destroyed, the Legal Affairs Section, which is part of the Governance Management Headquarters, conducted an investigation without the knowledge of Employee X and recognised suspicion of fraudulent subcontracting. The chief of the Governance Management Headquarters reported to the President and the chief of the Administration Headquarters, who immediately started an internal investigation (preliminary survey) and shared the information with the accounting auditor, the auditing firm.

### **(3) Employee X's background**

It is recognised that Employee X is the Company's leading expert in his area of expertise and has contributed to the Company's expansion in this area as a management engineer.

In April 2009, he became the head of a divisional office at business office B. He went on to become the head of the office at business office C and the head of the division at business office A. The head of the divisional office is the decision-making authority for subcontracting requests of less than 3 million yen.

### **(4) Confirmed facts**

#### **1) Establishment and operation of Company Y**

Employee X established Company Y on 9 October 2007 with an acquaintance as its representative director. Employee X is the effective owner of at least a majority of the shares in Company Y and also in control of the company's seal and bank accounts.

Company Y's head office is located in Chuo-ku, Tokyo, and the location is a virtual office that rents out its registered address.

The representative director at the time that the present case was discovered was Mr P. Mr P's spouse is a former part-time employee of the Company and an acquaintance of Employee X. Mr P was appointed to the position at the request of Employee X in a name-lending arrangement and was not involved whatsoever in the management of Company Y. In addition, a relative of Employee X was a director of Company Y for a period of time.

After Employee X assumed the position of representative director on 12 August 2023, Company Y resolved to dissolve on 14 August 2023 and completed registration procedures effecting that Employee X had assumed the position of representative liquidator.

#### **2) Subcontracting to Company Y, etc.**

##### **(a) Size of transactions, etc.**

Transactions began in November 2009 (month recorded), and the last transaction was in April 2023 (month recorded). The total number of transactions was 55, and they had a total value of JPY 108,929,200 (including tax).

Of these, 42 were subcontracted (total value: JPY 105,310,900 [including tax]), and 13 were paid for by expenses (total value: JPY 3,618,300 [including tax]).

##### **(b) Transactions in the engineering division of business office A**

When Employee X was the head of the engineering division of business office A, four work orders having a total value of JPY 5,676,000 (including tax) were placed with Company Y. The substantiation investigation showed that none of the subcontracting to Company Y relating to documents drafted by Employee X could be confirmed as having a subcontracted deliverable corresponding to subcontracting specifications.

Employee X, under instructions to store subcontracted deliverables at business office A, obtained and altered the data of the subcontracted deliverables and reports of another company from the server of the engineering division of business office A for two subcontracts and sent them to the subcontracting manager of the engineering division of business office A as the subcontracted deliverables of Company Y. When the investigation found that Company Y's subcontracted deliverables were very similar to those

of other companies, Employee X admitted that they were made to resemble those of other companies.

Employee X explained that the funds obtained by Company Y from the four cases, including the two cases described above, were used for software improvements. However, when the investigation found that the improved software did not exist within the company, Employee X significantly changed his explanation, saying that he was still gathering information and had not yet implemented any improvements. However, Employee X gave no explanation as to why he had changed his explanation. In light of the fact that such a drastic change of explanation is unreasonable and unnatural from the standpoint of common practice, and no explanation has been given as to why, there was no choice but to consider Employee X's initial explanation is a falsehood made to cover up the lack of subcontracted deliverables.

Accordingly, Employee X is determined to have drained the total amount of JPY 5,676,000 (including tax) related to four cases in the engineering division of business office A from the Company through transactions without substance.

- (c) Transactions with Company Y in the engineering division of business office B and the engineering division of business office C, etc.

With regard to the subcontracting to Company Y (relating to documents drafted by Employee X) in the engineering division of business office B, the engineering division of business office C, and the engineering division of business office A, besides those in (a), the total number of transactions was 51, and the total value was JPY 103,253,200 (including tax). The substantiation investigation was unable to verify the subcontracted deliverables corresponding to the subcontracting specifications. Employee X explained that the funds received by Company Y were used for operational-productivity assistance and software development.

- a) No evidence of operational-productivity assistance by Company Y could be found

With regard to said operational-productivity assistance, Employee X explained that Company Y had students carry out calculations and field investigations and that he himself received the subcontracted deliverables via hand-delivered CDs, MOs, and USB flash drives. Employee X was instructed to provide records and data of communication regarding the subcontracted deliverables, but Employee X replied by email that he had nothing to submit. In addition, interviews with the parties concerned, as well as a digital forensic investigation, were conducted to determine whether or not Company Y was involved in assisting with improving operational productivity. However, no trace or evidence indicating that Company Y was involved could be found.

- b) No evidence of software development or improvement by Company Y could be found

With regard to software development, Employee X claimed that the development was for software for internal use and had not caused any damage to the Company. Employee X's claim that he, in an appropriate position at the time, dared to commit an obvious breach of internal rules by having Company Y carry out software development work that was not included in the subcontracting specifications is unnatural and unreasonable in light of common sense and lacks credibility unless there are exceptional circumstances in play.

Employee X explained that, despite the subcontracting specifications not stipulating as such, Company Y had students develop and improve the software and that he himself received the subcontracted deliverables via hand delivery of the data stored on media such as CDs, MOs, and USB flash drives. Therefore, the investigation attempted to verify the existence of said software and determine whether or not Company Y was involved in the development and improvement thereof.

The investigation ultimately found Excel spreadsheets and software to calculate the forecast results on Company servers, so investigators instructed Employee X to provide records and data received from Company Y. However, Employee X replied by email that he had nothing to submit.

Furthermore, interviews with the persons concerned, as well as a digital forensic investigation, were conducted to determine whether Company Y was involved in developing these Excel spreadsheets and software. However, no evidence indicating that Company Y was involved in the development and improvement thereof was found.



c) The explanation given by Employee X is not credible

From the above, it is clear that, with regard to his explanation that Company Y was involved in operational-productivity assistance and software development, Employee X himself was unable to provide evidence of Company Y's involvement, and no evidence of Company Y's involvement in the operational-productivity assistance and software development could be found through the digital forensic investigation or interviews with the persons concerned. In addition, Employee X has made claims that are unnatural and unreasonable in light of common sense without presenting any documents or other evidence to support his claims.

d) Employee X is determined to have drained funds from the Company through transactions without substance

Therefore, the Committee found no evidence that Company Y was involved in assisting with improving the Company's operational productivity or developing and improving software used by the Company, and Employee X has no choice but to admit that the entire amount of JPY 103,253,200 in 51 cases at the engineering division of business office B, the engineering division of business office C, and the engineering division of business office A, besides those in 2) (b), was drained from the Company through transactions without substance.

3) Transactions with Company Y via Company Z

(a) Summary of transactions through Company Z

Company Z is an actual company that carries out investigations and measurements, etc. It has a record of having dealt with us since 1997.

The transactions involving Employee X started in February 2008 (the month recorded) and ended in April 2023 (the month recorded), with a total of 15 transactions totalling JPY 32,613,000 (including tax). The final payment of JPY 3,300,000 (including tax) recorded in April 2023 was paid by the Company to Company Z. However, before the payment was made by Company Z to Company Y, the investigation into the case was conducted and the payment from Company Z was suspended, so Company Y did not receive that payment.

In the transactions, Employee X instructed Company Z's sales representative to place an order for work with an artificial (labour) cost added to Company Z's estimate (with an item added to the transaction at the engineering division of business office A recorded in April 2023), and Employee X later sent Company Y's invoice to the Company Z sales representative to receive payment for the added cost. Both the Company Z sales representative and Employee X acknowledged the arrangements of the work orders, etc.

(b) The explanation given by Company Z's sales representative is credible

The sales representative of Company Z acknowledged not only the arrangements of the work orders, etc. but also that the transactions with Company Y were carried out at the request of Employee X, that he never received any subcontracted deliverables from Company Y, and that the entire transaction through Company Z at the request of Employee X was without substance.

The explanation of the sales representative of Company Z is credible because he admitted to the transactions without substance conducted at the request of Employee X, admitted to matters leading to his own disadvantage, and promised to respond sincerely to any additional investigations, in addition to being in line with the results obtained by the Committee's investigation. The explanation should be considered credible.

(c) The explanation given by Employee X is not credible

In contrast, Employee X explained that the transactions through Company Z were transactions with substance, which is at odds with the explanation given by the Company Z sales representative. The credibility of Employee X's explanation is examined below.

a) The explanation that the company went through Company Z is unreasonable

Employee X explained that, with regard to transactions via Company Z, he thought that it would not be acceptable to place a large order with Company Y, which is a small company, so he placed an order for part of the amount he originally ordered from Company Y via Company Z. However, as

the Company places no limit on the amount of money that can be used for subcontracting if there is an appropriate reason, regardless of the size of the subcontractor, Employee X's explanation is unreasonable, and Employee X should be determined to have attempted to cover up the transactions with Company Y in particular.

b) The explanation of the transaction in the engineering division of business office A is unreasonable

Employee X explained that, of the JPY 32,613,000 (including tax) of work described in (a), with regard to the JPY 3,300,000 (including tax) of work recorded in April 2023, which was ordered when Employee X was the head of the engineering division of business office A, it was legitimate for Company Y to receive such payment because the initial purpose of the order was to improve software and the order was a transaction with substance involving the delivery of improved software.

However, the results of the Commission's investigation confirm that there was no such improved software in the Company. The explanation given by Employee X is thus contrary to the results of the Commission's investigation and the credible explanation given by the Company Z sales representative.

Furthermore, when Employee X was shown that no improved software existed within the Company, Employee X changed his previous explanation, stating that he was still gathering information and had not yet implemented any improvements. Such a drastic change of explanation is unnatural and unreasonable.

c) The explanations given by the engineering division of business office B and the engineering division of business office C regarding transactions with Company Z are unreasonable

Employee X explained that, of the JPY 32,613,000 (including tax) described in (b), it was justifiable for Company Y to receive JPY 29,313,000 (including tax) of work paid thereto via Company Z because he himself had directly received the subcontracted deliverables from Company Y and it was a transaction with substance.

However, according to the results of the Committee's investigation, no evidence of subcontracted deliverables by Company Y could be found within the Company. The explanation given by Employee X is contrary to the findings of the Commission's investigation and the credible explanation given by the Company Z sales representative.

Furthermore, when the Committee instructed Employee X to provide records and data showing the delivery of subcontracted deliverables from Company Y to Employee X, Employee X simply replied to the Committee by email, without giving any particular reason, that he had no records or data to provide, and he did not provide any records or data to support the reasonableness of his explanation.

Considering that Employee X owns at least a majority of the shares in Company Y and is the effective manager of the company, it is unnatural and unreasonable for Employee X to be unable to provide any records or data that should naturally be in the possession of Company Y and would demonstrate the reasonableness of his explanation.

d) The explanation given by Employee X is not credible

Therefore, Employee X's explanation that the transactions with Company Y via Company Z were with substance and that Company Y was justified in receiving payment is unreasonable and cannot be trusted. As with 2) (b), we have no choice but to determine that Employee X's explanation is a falsehood made to cover up the lack of subcontracted deliverables.

(d) Summary

The explanation given by the Company Z sales representative that the transactions with Company Y via Company Z were without substance can be trusted, whereas the explanation given by Employee X that the transactions with Company Y via Company Z were transactions with substance and that Company Y was justified in receiving payment cannot.

Therefore, it is determined that the amount of JPY 3,300,000 (including tax) described in (c) b) was leaked out of the Company through transactions without substance. In addition, as far as it has investigated, the Committee has no other alternative but to determine that JPY 29,313,000 (including

tax) pointed out in (c) c) flowed out of the Company through transactions without substance.

4) Transactions with Company Y via subcontractors other than Company Z

With regard to subcontracting relating to documents drafted by Employee X, interviews were conducted with seven companies other than Company Z that had performed subcontracted work in the past five years. However, with the exception of Company Z, neither evidence of orders placed with Company Y via the subcontractor nor evidence of the orders being returned was confirmed.

5) Transactions with companies other than Company Y relating to documents drafted by Employee X

The investigation focused on 86 cases (20 companies) of subcontracting to companies other than Company Y relating to documents drafted by Employee X, focusing on work for which subcontracting request–approval forms were preserved. Evidence of subcontracted deliverables was confirmed in all cases with the exception of the transactions mentioned in 3) and older transactions whose subcontracted deliverables were not sufficiently organised at the time.

In addition, it was confirmed that there was no excessive increase in expenses and purchase transactions for which Employee X had approval authority, and that several payment records were extracted and subcontracted deliverables existed.

6) Conclusion

Some of the transactions with Company Y in the engineering division of business office A (four ordered from Company Y when Employee X was the head of the engineering division of business office A, the total amount of which was JPY 5,676,000 [including tax]) and transactions with Company Y via Company Z (JPY 3,300,000 [including tax]) recorded in April 2023, which were ordered when Employee X was the head of the engineering division of business office A, were without substance. Employee X is thus determined to have drained the entire amount of JPY 8,976,000 (including tax) from the Company for the transactions and caused the same amount of damage to the Company.

With regard to transactions with Company Y other than those mentioned above (51 transactions, the total amount of which was JPY 103,253,200 [including tax]), software development was not included in the subcontracting specifications, which is a violation of internal regulations. Furthermore, no records or data were submitted by Employee X, nor was any evidence found during the Committee's investigation indicating that Company Y was involved in the development and improvement of the software or in assisting with improving operational productivity. No evidence could be found of the exchange of subcontracted deliverables for the added costs. Taking into account the fact that Employee X has given unnatural and unreasonable explanations without presenting any documents or other evidence to support his claims, it should be concluded that his explanations cannot be trusted. Therefore, as far as the Committee has been able to ascertain, these transactions were without substance, and the Committee has no choice but to determine that Employee X drained the entire amount of JPY 132,566,200 (including tax) from the Company and caused the same amount of damage to the Company.

From the above, the total amount of the inappropriate subcontracting by Employee X is JPY 141,542,200 (including tax).

**(5) Motivation and opportunities for fraud**

1) Motivation for fraud

Employee X explained that he had set up Company Y to provide operational-productivity assistance and software development and that he had subcontracted work from the company.

However, this explanation lacks rationality, as the normal approach for the above-mentioned purpose includes directly employing part-time workers and ordering software development through formal procedures. As Employee X did not give an explanation for this lack of rationality, the true intention behind the establishment of Company Y is unclear.

However, Employee X explained to the Committee's investigators that he had 'led the field as a leading expert in a certain specialised field and contributed to the expansion of orders and improvement of profitability' and that he 'thought he could use part of the profits from his own work for himself'. Even before the fraud in question came to light, Employee X had appealed to the Company on the grounds that he had generated more profits in his field than others had and that he deserved more recognition. Furthermore,

Employee X had expressed dissatisfaction with his remuneration and treatment in the Company, such as the fact that although he had been promoted to the management group earlier than other employees, he had remained at the managerial level since, and had made annual requests to several Company executives for a promotion to a senior position.

In addition, the Committee examined Employee X's voluntary submissions of the tax returns of Company Y for the years ended 31 July 2008 to 2022 (excluding the year ended 31 July 2011). The Committee also examined Employee X's tax returns for the period from July 2008 to July 2022 (excluding July 2011) and the general ledger for the period from July 2017 to July 2022, which Employee X is required to prepare for tax purposes, and found that Employee X admitted that entertainment expenses totalling JPY 3,925,700 spent at Company Y were for his own meals and drinks, that Company Y rented a house under Employee X's name from his spouse, and that he had been a member of Company Y's board of directors for at least five years. It was determined to be highly likely that Employee X had privately misappropriated funds that had flowed out of the Company to Company Y, based on evidence such as the fact that Employee X had paid at least JPY 5,144,874 over a five-year period to Company Y for renting a house in Employee X's name from Employee X's spouse.

Taken together, these facts suggest that Employee X was dissatisfied with his remuneration and treatment for the profits and contributions he had made.

## 2) Opportunities for fraud

### (a) Company-wide controls

The core components of the Company's internal controls over subcontracting are the work management conducted by work-management engineers, the examination of subcontractors, subcontracting-request approval, inspection, and acceptance inspection by the engineering division offices, and the general administration division of the business offices, etc. The following procedures have been established in anticipation of possible risks associated with subcontracting.

'Guidelines for Handling Subcontracting' (partially amended on 1 December 2021 and 1 October 2022).

Handling of the 'Delivery Document/Inspection Result Notification' (amended 1 December 2021).

'Guidelines for the Management of Subcontracting' (revised July 2021).

The Company has made the following amendments to these procedures following the discovery of an inappropriate subcontracting transaction the year before last.

#### a) Stricter registration-renewal procedures for subcontractors, etc.

- Subcontractors that have passed the examination based on the 'Record of Examination of Subcontractors' are to be registered.
- The relationship between the employees of the subcontractor and the employees of the Company is to be described on the 'Application for Participation as a Subcontractor'.
- A field to describe the circumstances leading to the new registration has been added.
- A hotline for receiving reports of unreasonable demands made by employees of the Company has been established.

#### b) Stricter approval decisions on subcontracting requests

- The general manager of the General Affairs Division of the business office designates subcontracting to be managed intensively (priority management work). (Priority management work includes work ordered from subcontractors who are relatives or acquaintances of employees as well as work for which the specifications and outcome are unclear at the start of work.)

#### c) Clarification of inspection and acceptance of subcontracted deliverables

- Subcontracted deliverables and the 'Delivery Document/Inspection Result Notification' are stored in a designated folder to ensure that the validity of the order can be verified by a third party.
- The roles of those serving as examiners and inspectors are clearly stated.
- Priority management work is inspected separately by an external inspector from outside the divisional office (the general manager of the General Administration division of the business

office or a person nominated thereby).

d) Implementation of post-event monitoring

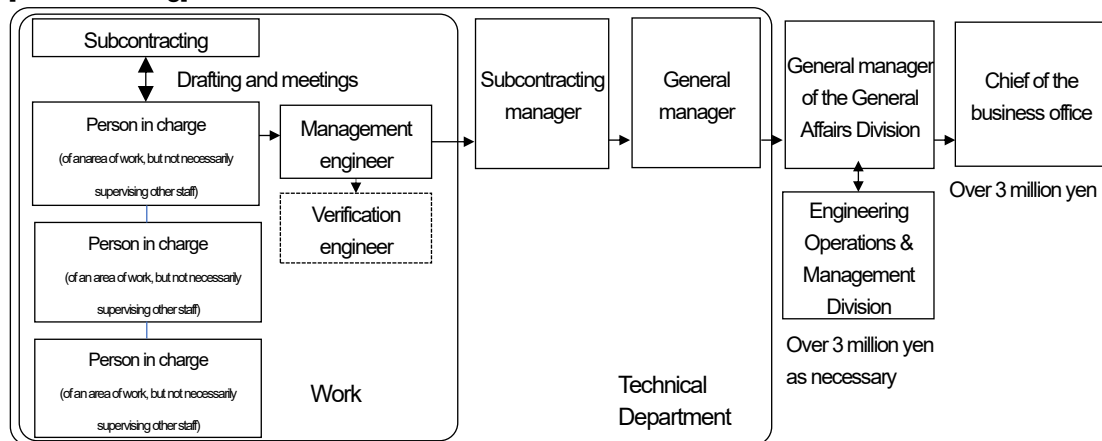
- The general manager of the General Affairs Division of the business office carries out periodic post-event monitoring.
- Priority management work is identified via screening using computer-assisted audit tools (CAATs) and checked in the same way as external inspections for key management operations.

e) Training of staff responsible for subcontracting

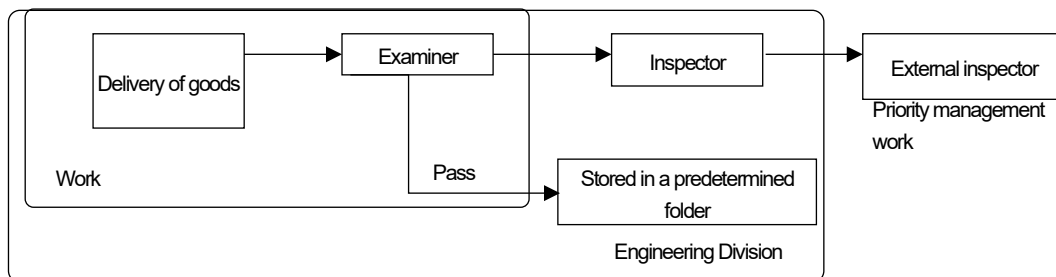
- Training is provided for persons responsible for subcontracting in the General Affairs Division of the business office on specific management methods for subcontracting affairs and detecting fraudulent subcontracting.

An overview of the procedural flow for and the roles of persons involved in the company's subcontracting procedures is given below.

[When ordering]



[At delivery]



	Role in subcontracted ordering, inspection, and acceptance
Management engineer	As the person responsible for overseeing operations, the management engineer manages costs, subcontracting, processes, quality, etc. The management engineer determines the nature of the work to be subcontracted at the time of work planning.
Person in charge (of an operation)	Generally, the work is carried out by several persons who share and collaborate under the direction of the management engineer. The person in charge of the subcontracting part of the work prepares the subcontracting specifications, drafts the approval documents, and holds meetings with the subcontractor.
Verification engineer	The verification engineer performs engineering verification of the subcontracted deliverables.
Divisional subcontracting manager	The divisional subcontracting manager manages subcontracting within the division.

General manager	The general manager makes decisions on subcontracting-request approvals worth less than 3 million yen.
General manager of the General Affairs Division	The general manager of the General Affairs Division checks the application forms for the registration of a company as a subcontractor, reviews the adequacy of the subcontracting request–approval procedures, and accepts the approval forms. The general manager of the General Affairs Division also designates priority management work based on subcontracting and subcontracting details and conducts post-event monitoring.
General manager of the Engineering Operations & Management Division	The general manager of the Engineering Operations & Management Division checks the subcontracting plan and other aspects of the subcontracting approval process for subcontracting requests worth more than 3 million yen.
Chief of the business office	The chief makes decisions on subcontracting requests worth more than 3 million yen.
Examiner	After receiving the subcontracted deliverables from the subcontractor, the examiner inspects whether the type of work, content, quantity, quality, etc. of the subcontracted deliverables are all in order in accordance with the subcontracting specifications (Guidelines for Handling Subcontracting). If the subcontracted deliverables have passed the inspection, the electronic files, etc. of the subcontract deliverables are stored in a designated place as specified by the division office (Guidelines for Handling Subcontracting, revised 2021). The engineer in charge or the verification engineer serves this role.
Inspector	After checking the inspection results, the inspector checks subcontracted deliverables against the subcontracting specifications to ensure that they satisfy the outcomes stipulated in the specifications (Guidelines for Handling Subcontracting). The management engineer or divisional quality officer serves this role.
External inspector	For priority management work and work requiring confirmation by an external inspector, the external inspector checks the inspection results to ensure that the subcontracted deliverables are consistent with the subcontracting specifications and that the results specified in the specifications are satisfied (Guidelines for Handling Subcontracting, revised 2021). The general manager of the General Affairs Division of the business office or a person nominated thereby serves this role.

(b) Registration and renewal of subcontractors

Subcontractor registration is subject to preliminary screening by the person in charge (checking the certified copy of the register and the list of engineers submitted by the subcontractor), and subcontractors that have passed the screening by the subcontracting manager of the engineering division and General Affairs Division of the business office may conduct transactions (Guidelines for Handling Subcontracting). In the revision of the same guidelines in 2021, checks were added to identify subcontractors that are prone to fraud by checking their relationships with the Company’s employees and their track record of similar work.

Company Y’s Application for Participation as a Subcontractor was updated in July 2022, but the General Affairs Division of the business office was not aware of relatives’ connections to Company Y, as the application had declared that no Company Y employee had relatives or acquaintances at the Company.

According to interviews with those in charge of operations, no employee other than Employee X was found to have had direct meetings or exchanged documents with Company Y. Even those in charge of operations were aware of the subcontracting to Company Y only through the working budget

documents. In addition, as Employee X was the head of the division and a management engineer, other employees could not suspect a relationship between him and Company Y.

Even after registration, due to the absence of other divisions and other document drafters, etc., no one other than Employee X had direct contact with Company Y, which may have contributed to the delay in the discovery of the case, as it was impossible to ascertain the actual situation at Company Y.

(c) Approval of subcontracting-request decisions

a) Selection of the party to order from

In the selection of a party to order from, at least two subcontractors with proven track records are selected based on the subcontracting specifications, and quotations are collected from the subcontractors based on the subcontracting specifications prepared by the person in charge. However, if urgent work is required, a special-order negotiated contract may be concluded under conditions such as the evaluation of the results of the previous work (Guidelines for Handling Subcontracting).

Company Y has been awarded all special-order negotiated contracts on the basis of its extensive experience in similar work. In addition, only Employee X had continuously placed orders with Company Y for many years.

b) Ordering procedures

The management engineer decides on the division of roles between the engineer in charge and the verification engineer in charge of the work and selects the work to be subcontracted, taking into account various aspects such as the work content, engineering characteristics, ensuring and improving quality, the work experience of the engineer in charge, ensuring and improving in-house engineering capabilities, training subcontractors, and contract compliance (Guidelines for the Management of Subcontracting). In doing so, based on the quotation for the work submitted by the Company to the ordering party, the estimated subcontracting amount is determined according to the subcontracted task's estimated subcontracted portion, and a working budget is prepared according to the subcontracted content and price negotiations with the subcontractor (Guidelines for the Management of Subcontracting).

After deciding on the details of the subcontracting, a circular for approval is drafted in accordance with the Guidelines for Handling Subcontracting and the Guidelines for the Management of Subcontracting. If the subcontracting amount is more than 3 million yen, the approval of the chief of the business office is required in addition to the approval of the general manager, and split orders for the same matter are prohibited (Guidelines for Handling Subcontracting). In addition, in the 2021 revision of the same guidelines, the general manager of the General Affairs Division of the business office is required to designate as priority management work those tasks for which orders are placed with subcontractors who are relatives or acquaintances of employees, in addition to tasks for which the specifications and outcome are deemed unclear at the start of the task, and to monitor these tasks intensively.

Employee X was the management engineer of the work or the main person in charge of the work, separate from other divisions, etc., and was in charge of managing the working budget. The subcontracting documents drafted by Employee X were consistent with the estimated amount of tasks to be subcontracted and the subcontracting amount, and the construction period, subcontracting rate, and cost rate were all in line with each other, with no unnatural elements found. The checks by the management engineer had been eliminated.

Employee X was the head of division and the decision-making authority for subcontracting requests worth less than 3 million yen. If the head of the division is a management engineer or the person in charge of the divisional work, he or she can independently execute the subcontracting of the work concerned, from drafting to approval, and Employee X took advantage of this to circumvent the internal controls in the division.

In the case of subcontracting inspected by the divisional subcontracting manager, Employee X showed what appeared to be the subcontracted deliverables so that they could pass inspection.

The fact that no one other than Employee X, who is also a management engineer and division head, was involved in some of the work related to the subcontracting is the reason that the fraud could not be detected at an early stage.

The divisional subcontracting manager checks the subcontracting amount, quotation, content of the approval request, specifications, etc., before the application is submitted, and if the content or quantity of the quotation is unclear, the application is sent back. In this case, however, approval was given because the details, including the working budget, appeared consistent on the surface.

The General Affairs Division of the business office also checked the items, reasons, content, quantities, and construction period of the subcontracted work against the working budget and approved them, as they were consistent.

(d) Inspection and acceptance procedures for subcontracted deliverables

According to the Company's regulations, subcontracted deliverables are to be inspected and accepted within five working days from the date of their receipt. The examiner is to be the engineer in charge or the verification engineer, who is to inspect whether the type of work, content, quantity, quality, etc. of the subcontracted deliverables are all in order according to the subcontracting specifications. The inspector is to be the control engineer or the person in charge of quality in the division office, who, after checking the inspection results, is to check the subcontracted deliverables against the subcontracting specifications and confirm whether they satisfy the results stipulated in the specifications (Guidelines for Handling Subcontracting).

In the 2021 revisions to the guidelines, the roles of examiners and inspectors are clarified, and the following items are added to ensure that inspections are carried out by external inspectors for priority management work.

- After receiving the deliverables from the contractor, the examiner is to inspect whether the type of work, content, quantity, quality, etc. of the deliverables are all consistent with the subcontracting specifications. If the deliverables pass the inspection, the electronic files, etc. of the deliverables are to be stored in a designated place as specified by the divisional office.
- After reviewing the inspection results, the inspector is to check the deliverables against the subcontracting specifications to ensure that they satisfy the outcomes stipulated in the specifications.
- The external inspector is to check the results of the inspection against the priority management work and tasks deemed necessary to be checked by the inspector to ensure that the subcontracted deliverables are consistent with the subcontracting specifications and that the results specified in the specifications are satisfied.

Of the subcontracting procedures involving Company Y, Employee X was the examiner in 34 out of 42 cases and the inspector in 6 cases. It should be noted that Employee X, who is in charge of subcontracting and is also a management engineer, is permitted to be an examiner or inspector.

The inspector of subcontracting for which Employee X was the examiner was the deputy director of the engineering division or the divisional subcontracting manager. Acceptance inspection plays an important role in checking the results of the inspection, comparing the subcontractor's deliverables with the subcontracting specifications, and confirming that the results specified in the specifications are satisfactory. However, in cases where the divisional subcontracting manager inspected and accepted the subcontract, he was shown a portion of the deliverables by Employee X, which was incorporated into the deliverables to be delivered by the Company, and he signed and sealed the document believing the claim that said portion had been subcontracted. The problem is that, despite being an instruction from a higher-ranking division head, the procedure did not follow the rules and regulations, as evidenced by the fact that the inspector did not check the deliverables against those from the subcontractor, and the procedure was a mere formality.

The subcontracting for which Employee X was the inspector was examined by a young employee in charge of the work or the divisional subcontracting manager. Some younger employees stated that they signed the inspection documents as they were told by Employee X, although they have only



vague recollections thereof. In the subcontracting where the divisional subcontracting manager was responsible for examination, Employee X passed the inspection by showing what appeared to be subcontracted deliverables.

Although the regulations require that subcontracted deliverables in subcontracting transactions are stored in a designated folder, Employee X did not do this. After Employee X's transfer to another office, a member of the engineering division of business office A, who was referring to work done in previous years when Employee X was a management engineer, was unable to find the subcontracted deliverables of Company Y in the designated place and reported it to his superior, which triggered the discovery of the incident. The protocols were thus deemed to be effective to a certain extent.

(e) Priority management work and post-event monitoring at business offices

In the 2021 revision of the Guidelines for Handling Subcontracting, in order to strengthen internal controls outside the division, work deemed important by the head of the General Affairs Division of the business office is to be designated as priority management work. The designation of priority management work covers work ordered from subcontractors who are relatives or acquaintances of employees, work for which the specifications and outcome are deemed unclear at the time the work is started, etc.

In addition, in order to ensure that checks and balances are in place from outside the division, the general managers of the business offices regularly carry out post-event monitoring of subcontracted deliverables. Post-event monitoring is carried out in the same way as that for the external inspection of priority management work, by screening the targeted tasks using tools such as CAATs.

Some post-event monitoring is carried out by the General Affairs Division of the business office, but it is carried out infrequently throughout the company, and this case was not covered.

These measures were also identified in the 2022 internal audit as insufficiently designated priority management work due to the lack of clear definitions of known persons.

From the above, it can be considered that the case could have been prevented if the procedures and guidelines had been properly implemented, and it can be confirmed that 'the management system was in place to the extent that it could prevent the fraudulent activity that would normally be expected'. However, it can also be confirmed that, since Employee X was the head of the division, other employees trusted Employee X and the inspection and acceptance of the work had thus become a formality, that the operations concerning the designation of priority management work was insufficient, and that Employee X abused his position as a management engineer or person in charge of divisional work and conducted fraudulent subcontracting in a such a manner that it would not be exposed. This made it impossible to prevent the occurrence of the incident, thereby preventing the early detection of the fraud.

### 3 Investigation of similar cases

#### (1) Investigation methods

Based on the characteristics of the subcontracting in question, the following requirements were identified for the Company and its consolidated subsidiaries, and the existence of subcontracted deliverables was checked.

Item	Description
Continuous subcontracting by specific persons to specific subcontractors	Orders that have been continuously placed by a specific document drafter to a specific subcontractor for several years, with no document drafting by other employees
Drafting and approval of subcontracting requests by management engineers	Cases where the management engineer drafts the subcontracting request himself or herself and makes the decision himself or herself

#### (2) Investigation results

The results of the investigation of similar cases are shown below. No irregularities similar to those in this

case were found.

Company/consolidated subsidiary	Continuous subcontracting by specific persons to specific subcontractors	Drafting and approval of subcontracting requests by management engineers
CTI Engineering Co., Ltd.	Subcontracted deliverables present	Subcontracted deliverables present
CTI Engineering International Co., Ltd.	Not applicable	Not applicable
Japan Urban Engineering Co., Ltd.	Subcontracted deliverables present	Not applicable
Chi-ken Sogo Consultants Co., Ltd.	Subcontracted deliverables present	Not applicable
NISSOKEN ARCHITECTS /ENGINEERS	Subcontracted deliverables present	Subcontracted deliverables present
Environmental Research & Solutions Co., Ltd.	Subcontracted deliverables present	Not applicable
Waterman Group Plc	Subcontracted deliverables present	(See note)

Note: Waterman Group Plc is governed by English law, so the extraction of similar cases has been partially omitted.

#### 4 Financial impact and corrective action

The financial impact on profit and loss due to inappropriate subcontracting transaction, etc. identified by this investigation is as follows.

##### (1) Impact on financial figures for previous years

The total amount of the inappropriate subcontracting transaction carried out by Employee X, JPY 141,542,200 (including tax), is not retrospectively adjusted because the impact on net profit attributable to shareholders of the parent company for each year from December 2008 to December 2022 is less than 1% and the impact for each accounting period is immaterial.

##### (2) Impact on FY2023 2Q results

As stated in the report for the second quarter of 2023, published on 14 August 2023, the company recorded a fraud-related loss of 3 million yen in cost of sales related to fraudulent subcontracting that occurred during the period under review as a fraud-related loss in the 'Other' category under non-operating expenses. In addition, a total of 47 million yen of consumption tax and income tax for previous years was recorded as a settlement of provisional consumption tax payment overstated in previous years.

##### (3) Treatment of consumption tax and income tax for previous years

With regard to errors in consumption tax and income tax for previous years, in the 2023 tax return in which the fraudulent subcontracting was revealed, consumption tax of 9 million yen will be deducted from the purchase tax credit, and 125 million yen will be added to the income amount.

#### 5 Recommendations on measures to prevent recurrence

##### (1) Strengthening compliance training and internal controls

###### 1) Thorough compliance training

This case was a deliberate act of misconduct by Employee X, who was in a managerial position, and the fact that such an incident has come to light following the subcontracting-related fraud discovered the year before last is a bitter blow for the Company. It is necessary to consider reenforcing training for all employees on how to carry out their work in accordance with Company rules, regardless of reason, including, of course, avoiding fraudulent activity.

###### 2) Strengthening the effectiveness of internal controls

In the Company's case, it is the individual engineering divisions that are in a position to directly operate internal controls, and it is thus necessary to educate and raise awareness so that division heads, examiners,

and inspectors and persons responsible for subcontracting are aware that they play an important role in internal controls.

## **(2) Responses to issues in subcontracting systems**

### **1) Stricter subcontracting registration and renewal procedures**

#### **(a) Strengthening checks on the actual status of subcontractors**

The Application for Participation as a Subcontractor was updated to include stronger provisions for relationships with the Company's employees and the confirmation of similar work experience. However, in this case, the actual status of Company Y could not be verified because, at the time of the 2022 update, there was no declaration that the persons related to Company Y were relatives or acquaintances of Company employees, and Company Y, at least on paper, had a track record of performing work.

In order to assess subcontractors, it is necessary not only to strengthen the examination of documents but also to assess the actual situation through face-to-face meetings and interviews, as appropriate, for subcontractors who place orders under special-order negotiated contracts or continuously receive orders from a specific employee.

#### **(b) Transparency of subcontracting transactions**

The fact that only Employee X handled the paperwork with Company Y during the performance of his duties and that no one else had knowledge of the actual situation at Company Y was also a reason for the delay in the discovery of the case.

To ensure that relationships with subcontractors cannot be kept secret, it is considered effective to make the status of discussions and the transfer of subcontracted deliverables transparent through the use of mailing lists, cloud servers, etc. so that the persons involved in the work and the management-related divisions can check them at any time.

### **2) Stricter subcontracting request–approval procedures**

#### **(a) Improved operations of subcontracting request–approval procedures**

There is a need to tighten the checks on the reasons for special assignments of contracts and the appropriateness of the corresponding amounts.

In addition, in the case in question, some work was processed as expense payments, even though the documents should have originally been drafted for subcontracting approval. In order to avoid this, it is necessary to reinform employees of the type of work eligible for processing as expense payments and ensure that documents for work not falling under this category are drafted and approved via the subcontracting request–approval process.

#### **(b) Avoidance of concentration of authority**

In this case, the fact that Employee X was the head of the division and also a management engineer was a major factor in making the inappropriate subcontracting transaction possible. At the Company, it is rare for the head of a division to be both a management engineer and a document drafter, and less than 1% of the several thousand subcontracting requests submitted every year are drafted by such persons. However, it should be assumed that such cases can occur, especially in smaller divisions.

Management engineers have supervisory authority over their work, and when they themselves subcontract work, it must be checked by a third party familiar with the work. Furthermore, it is necessary to strengthen the checks and balances from outside the division by, for example, having the chief of the business office make decisions when the general manager of the division drafts proposals.

### **3) Strengthening the effectiveness of inspection and acceptance**

Although reliable inspection and acceptance of subcontracted deliverables is the most important process, in this case, the inspection and acceptance of subcontracted deliverables had become a formality, partly because Employee X was the document drafter (originator) and superior of the subcontracting request–approval process. In addition, the inspection did not function because Employee X, the originator of the fraudulent subcontract, was the examiner. The following measures need to be urgently considered in order

to make them effective.

(a) Strengthening the effectiveness of inspections

Examiners need to have an understanding of the work and objectivity, and it is necessary to designate a person in charge who has a certain level of knowledge of the work but is not the subcontracting originator. In addition, in order to monitor the implementation of inspections, it is necessary to strengthen effectiveness by requiring evidence of inspection results to be registered together with the subcontracted deliverables.

(b) Strengthening the effectiveness of acceptance inspections

The effectiveness of acceptance inspections needs to be strengthened by ensuring that acceptance inspections are carried out on actual items and by requiring deliveries to be easily comparable with the items and quantities in the subcontracting specifications.

4) Strengthening of focused management and monitoring at business offices

The General Affairs Division and other administrative divisions, which are in a position to support internal controls from the side, need to strengthen checks and controls not only by checking workflows but also by using CAATs, etc. to identify numerical anomalies and check them individually. However, it is important to take effective measures, including the strengthening and reallocation of human resources, such as the allocation of personnel dedicated to external inspection and acceptance, and the utilization of IT technology.

It is also necessary to set and monitor management indicators for the implementation of recurrence prevention measures, such as the status of designation of priority management work, the percentage of negotiated contracts, and the status of registration in folders defined in the applicable rules.