

March 6, 2018  
Kobe Steel, Ltd.

## **Report on the Kobe Steel Group's misconduct**

We deeply and sincerely apologize once again for causing substantial troubles to our customers, business partners, shareholders, and other stakeholders due to the misconduct of Kobe Steel, Ltd. (the “Company” or “we”) and its Group (the “Group” or “Kobe Steel Group”).

On October 26, 2017, we established an Independent Investigation Committee chaired by Mr. Gan Matsui, an attorney-at-law and a former Superintending Prosecutor of the Fukuoka High Public Prosecutors' Office, to investigate the misconduct revealed by the quality self-inspections covering the Group's actual shipments for the past one year (September 2016 – August 2017) (i.e., the act of falsifying or fabricating inspection data for products falling short of public standards or customer specifications, and shipping or delivering those products to customers as if they conformed to the public standards or customer specifications, henceforth referred to in this release as the “Misconduct”). We have cooperated in full with the IIC's investigation.

In response to the latest results of the IIC's investigation, our Board of Directors has resolved to make public a report titled *Report on Misconduct in Kobe Steel Group* dated March 6, 2018 (the “Report”), which aims to explain facts revealed by the IIC's investigation, along with the outcomes of discussions at the Quality Governance Restructuring Deliberation Committee and the Quality Problem Investigation Committee, and reporting analyses of the causes of the Misconduct and measures to prevent a recurrence. We provide a summary of the Report below.

### **1. Facts relating to the Misconduct**

As of October 26, 2017, we announced that 525 of our customers had received nonconforming products from us, but the IIC's further investigation detected new cases of misconduct as shown in Table 1.

The new cases are those discovered in the process of the IIC's verification of and investigation into the Group's quality self-inspections, in addition to the four cases of potential Misconduct, which we announced on October 26.

We have already contacted customers about the new cases and have also completed safety verification for some of these cases. We will continue working by giving the highest priority to safety verification.

[Table 1: Locations where the Misconduct was found and the progress of safety verification]

As of March 6, 2018

Major category	Company name	Material	Main purpose	Announced on October 26, 2017		Since the IIC's establishment (October 26, 2017)	
				No. of customers	Safety verification	No. of customers	Safety verification
Aluminum & Copper	Kobe Steel, Ltd. Aluminum & Copper Business	Aluminum sheets	Can stock Cars	57	52	7 <sup>*4</sup>	6
		Aluminum cast & forged parts	Aircraft Rolling stock	67	67	4 <sup>*5</sup>	2
		Aluminum extrusions	Cars Rolling stock	34	34	-	-
		Copper sheets	Semiconductors Terminals	38	38	2 <sup>*6</sup>	2
	Kobelco & Materials Copper Tube, Ltd.	Copper tubes	Air conditioning	23	23	88 <sup>*7</sup>	87
	Shinko Metal Products Co., Ltd.	Copper alloy tubes, Molds	Electrical machinery, Steelmaking equipment	176	176	29 <sup>*8</sup>	1
	Domestic subsidiary: 1 Overseas subsidiaries: 3 <sup>*2</sup>	Copper tubes Copper strips Aluminum wires	Air conditioning Terminals	36	36	-	-
Shinko Moka Sogo Service Ltd.	Aluminum plate	Prototype materials	-	-	1 <sup>*9</sup>	0	
Other	Kobelco Research Institute, Inc.	Sputtering target materials Prototype alloys	FPD Optical disks Prototype alloys	70	70	14 <sup>*10</sup>	13
		Corrosion analysis	Corrosion analysis				
	Kobe Steel, Ltd. Iron & Steel Business Steel Powder Division	Steel powder	Sintered parts	1	1	-	-
	Domestic subsidiaries, etc.: 2 Overseas subsidiaries, etc.: 2 <sup>*3</sup>	Steel wire Stainless steel wire Heat treatment	Bearings Springs	22	22	-	-
	Shinko Kohan Kako, Ltd.	Heavy plate processing	Heavy plate processed products	1	1	-	-
	Koshuha All Metal Service Co., Ltd.	Heat treatment	Heat treatment	-	-	1 <sup>*11</sup>	1
	Kobe Steel, Ltd. Machinery Business	Machinery	Industrial machinery Standard compressors	-	-	10 <sup>*12</sup>	10
	Shinko Engineering Co., Ltd.	Machinery	Industrial machinery	-	-	3 <sup>*13</sup>	3
	Kobelco Eco-Solutions Co., Ltd.	Water analysis	Water analysis	-	-	4 <sup>*14</sup>	4
				<b>525<sup>*1</sup></b>	<b>520</b>	<b>163<sup>*1</sup></b>	<b>129</b>

The shadowed portions indicate the locations where the Misconduct was detected after the IIC's establishment.

\*1 The 525 customers announced on October 26, 2017 and the 163 customers affected by the Misconduct detected after the establishment of the IIC's are the cumulative numbers.

\*2 Shinko Aluminum Wire Co., Ltd., Kobelco & Materials Copper Tube (M) Sdn. Bhd., Kobelco & Materials Copper Tube (Thailand) Co., Ltd., and Suzhou Kobe Copper Technology Co., Ltd.

\*3 Nippon Koshuha Steel Co., Ltd., Shinko Wire Stainless Company, Ltd., Jiangyin Sugita Fasten Spring Wire Co., Ltd., and

Kobelco Spring Wire (Foshan) Co., Ltd.

\*4 A summary of each Misconduct identified with footnotes \*4 through \*14 is available at the following sections of Chapter 3 of the Report: \*4 Section 1(1) Misconduct (i)(ii)(iii); \*5 Section 1(2) Misconduct (i)(ii)(iii); \*6 Section 1(3) Misconduct (i)(ii); \*7 Section 3(1) Misconduct (i)(ii); \*8 Section 3(2) Misconduct (i)(ii)(iii)(iv)(v)(vi)(vii)(viii); \*9 Section 3(4); \*10 Section 4(6) Misconduct (i)(ii)(iii) and Section 4(7) Misconduct (i)(ii); \*11 Section 4(4); \*12 Section 2(2) Misconduct (i)(ii)(iii) and Section 2(3); \*13 Section 4(5) Misconduct (i)(ii); \*14 Section 4(6) Misconduct (i)(ii)(iii).

After looking at details surrounding the Misconduct, we confirmed that some staff falsified inspection data as if it met customer specifications or fabricated test data for unmeasured products as if they were actually measured.

The IIC's investigation revealed that the Aluminum & Copper Business was the only division where executive officers were involved in the Misconduct. Specifically, two executive officers, who once worked at plants where the Misconduct took place, were aware of the Misconduct but failed to report it to their superior who was the then head of the Aluminum & Copper Business. These executive officers did not themselves engage in the Misconduct. Another executive officer, who became aware of the Misconduct in April 2017, did no more than to decide, as a basic policy, to gradually eliminate the production and shipment of nonconforming products and he only instructed his staff to improve manufacturing processes and stop accepting part of the orders.

Of former executive officers, two directors / executive officers were found to have been directly involved in the Misconduct before taking office as an executive officer. Even after becoming executive officers, they neither reported the Misconduct to the Board of Directors nor took any actions to have the Misconduct halted or corrected.

As shown in Table 1, the Misconduct took place not only at the Aluminum & Copper Business but also at other divisions and Group companies. We take it very seriously the fact that the Misconduct took place at many locations within the Kobe Steel Group.

## **2. Analyses of the causes of the Misconduct**

Taking into account the results of the IIC's investigation and our own internal examination, we conclude that the causes of the Misconduct can be grouped into the following three categories : (1) the management style that overemphasized profitability and the inadequate corporate governance, (2) the imbalanced operation of plants that resulted in the reduced awareness of quality compliance among employees, and (3) the insufficient quality control procedures that allowed the Misconduct to take place. Details are provided below.

### **(1) Management style that overemphasized profitability and the inadequate corporate governance**

To align with the Head Office's emphasis on profitability, each business division felt the need to adopt an attitude that led them to accept purchase orders without reviewing their production capacities (the "Production-Over-Quality Attitude"). Further, a large-scale transfer of authority from the Head Office to each of the individual divisions weakened the Head Office's ability to assume centralized control over the entire Kobe Steel Group; this, in turn, led to the Head Office's inability to manage a compliance program that ensured effective quality assurance. Failure to detect the Misconduct at an early stage is also attributable to several factors relating to our corporate governance. For example,

even when conduct similar to the Misconduct was found in the past, the Company's management did not take drastic enough measures to address such issues. Internal audits at each division, moreover, were not sufficiently extensive.

- (2) Imbalanced operation of plants that resulted in the reduced awareness of quality compliance among employees

The motive for engaging in, and continuing to engage in, the Misconduct was created by the following factors: the manufacturing of products based on customer specifications not matched to process capability; a culture that prioritized winning purchase orders and meeting delivery deadlines over ensuring quality; an insular organization where personnel were rarely exchanged or transferred between different divisions; the absence of appropriate quality-related education / training and disciplinary actions; a false assumption that products falling short of customer specifications could be shipped to the extent that they had no safety issues; and the employee's quality compliance awareness dulled by a combination of the situations above.

- (3) Insufficient quality control procedures that allowed the Misconduct to take place

The Misconduct was provoked by certain issues on quality management processes, such as inspection processes enabling data falsification or fabrication, isolated and rigid operational systems, and the establishment of internal standards utterly impossible to conform to.

### **3. Measures to prevent a recurrence of the Misconduct**

Based on the cause analyses mentioned above and taking the IIC's suggestions into consideration, we have set out the following measures to prevent a recurrence of the Misconduct.

- (1) Measures in terms of governance— we will implement the following measures to restructure our quality governance systems

1. Penetration of the Group's corporate philosophy

We will pursue reforms aimed at restoring trust in the Kobe Steel Group by further promoting the "Next 100 Project" activities (a project to shape the Kobe Steel Group's future for the next 100 years), through which the top management talks to the employees face-to-face. Also, we will designate every October as "Core Value of KOBELCO Month" to keep remembering the lessons learned from the past compliance incidents including the recent Misconduct. In light of the significant impact the Misconduct had on the society, in addition, we will revise the "Six Pledges of KOBELCO," pledges to be kept by all employees, to include the expressions that emphasize customer satisfaction and contribution to the society.

2. Desirable state of the Board of Directors

To improve the fairness and transparency of the Board of Directors, we will ensure that at least one third of the members of the Board of Directors are independent outside directors, and will elect the chairman of the Board of Directors from among the independent outside directors. At the same time, we will abolish the Office of Executive Chairman and create a Nominating and Compensation

Committee as a voluntary advisory body to the Board of Directors. We will also revise the current structure under which all division heads are directors, and will assign one director position to the materials business, one director position to the machinery business, and one director position to the electric power business. In addition, we will also appoint a director overseeing compliance and a director overseeing quality management.

We will set up an Independent Quality Supervision Committee consisting of external experts, as an organization that is dedicated to discussing various issues about quality compliance, even after the IIC is dissolved.

3. Restructuring of the risk management system

We will conduct a Compliance Awareness Survey on a regular basis, strengthen the risk management of Group companies based on the Group's standards, formulate the "KOBELCO Quality Guidelines," and establish a Compliance Management Department under the guidance of an executive officer dedicated to compliance matters.

4. Reformation of the insular nature of organizations

We will aim to fundamentally reinforce governance by restructuring divisions and Group companies. We will reform the insular nature of organizations through personnel rotation among the divisions. We will take control of and resolve issues arising at worksites through implementation of measures such as employee awareness surveys.

5. Restructuring of the quality assurance system

We have adopted the "Quality Charter" to make all possible efforts to restore trust in the Kobe Steel Group. We have also established a Quality Management Department at the Head Office and a quality assurance section that is under the direct control of each division to reinforce the quality assurance system at each layer of our business: factories / plants, divisions, and the Head Office. The Quality Management Department oversees quality audits and the development of quality assurance personnel as well as support the divisions' quality education and training. In addition, we plan to invite from outside an executive officer in charge of the Quality Management Department around April 1, 2018.

(2) Measures in terms of management— we will implement the following measures to ensure quality management

1. Measures for quality management

We will strengthen quality assurance management at each business location in line with the quality guidelines, and will hold group quality leader conferences organized by the Quality Management Department. We will have the quality assurance departments conduct audit, and assist in solving issues arising at worksites through the "quality caravan team" activities carried out

by specialized personnel at the Head Office.

2. Education for and development of quality assurance personnel

We will regard quality assurance personnel as specialized personnel for the entire company, and will rotate and develop personnel in a manner that cuts across business divisions and locations. We will strengthen in-house education intended for all workers involved in quality at the Kobe Steel Group in accordance with the Quality Charter.

(3) Measures in terms of process— we will implement the following measures to strengthen quality control processes

1. Improvement of quality control processes

We will proceed with automating the processes of recording test / inspection data and eliminate as much as possible one-man operations in data entry processes. We will also adopt a single shipment standard to remove opportunities for the Misconduct that resulted from double shipment standards (customer specifications and internal standards).

2. Revision of the authorization process to be followed when receiving new orders

Some of the Misconduct resulted from the fact that when considering whether or not to accept orders from customers, we contracted with customers even though we did not fully understand our process capability, confirm specific testing / inspection methods, and sufficiently evaluate prototypes to meet customer specifications. In light of this situation, we will revise the authorization process to be followed when receiving new orders and also aim at understanding our process capability compared with customer specifications when receiving orders.

3. Revision of the authorization process to be followed when changing manufacturing processes

In certain cases of the Misconduct, discrepancies with specifications or motives for data tampering resulted from the failure to appropriately grasp the changes that had occurred to facilities or materials after the manufacturing started. Taking this situation into account, we will revise the authorization process to be followed when changing manufacturing processes affecting product quality.

#### **4. Conclusion**

Considering the facts relating to the Misconduct that were found by the Group's quality self-inspections and the IIC's investigation, together with multiple compliance incidents in which the Company was involved in the past, we must acknowledge that the Company is facing deep-seated issues concerning its organizational culture and awareness of its officers and employees, as well as its compliance systems.

In the process of investigating the causes of the Misconduct, we discovered the need to make reforms aimed at addressing issues more fundamental than issues that involved only quality, including those relating to

governance in general, not to mention issues with management and operational processes relating to the Company's quality assurance. We are also cognizant that there still remain issues that require further consideration, such as the desirable state of the Board of Directors, the desirable state of the division system, and the desirable methods of personnel allocation and development and of formulation of management plans.

We will continue to place the highest priority to completing the safety verification. At the same time, we will pursue fundamental reforms of our organizational systems and corporate culture by involving all of the Kobe Steel Group's employees, led by the top management, in diligently and earnestly implementing each measure to prevent a recurrence mentioned in the Report.

During the half-year-long investigation, we gained great cooperation from those concerned, especially our customers, in the safety verification and other processes, and also received very valuable advice and opinions. We would like once again to express our sincere gratitude for such support. For over 112 years since its founding, the Kobe Steel Group has managed its business by valuing trust of its customers, partners, shareholders, and a number of other stakeholders. The recent loss of such trust is truly regrettable.

To fulfill our responsibilities for the recent Misconduct and to be reborn as a company in which people can place their trust, we will go back to our roots (the "Base of *Monodzukuri*"), take to heart again the fact that reliable quality is the core of trust, strive to prevent a recurrence with an unwavering resolution, and commit ourselves to making this moment a true turning point.