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Critical Review of the Financial Statement Submitted by Cash Paymaster Services to the Constitutional Court on 30 May 2017

Introduction

1. The Alternative Information and Development Centre ("AIDC") has been approached by the Black Sash Trust and the Centre for Applied Legal Studies to provide an analysis of the financial statement ("the Statement") filed by Cash Paymaster Services (Pty) Ltd ("CPS") dated 30 May 2017.[1] The complete financial statement and narrative filed by CPS with the Constitutional Court is attached as **Annexure 1**.

2. The Statement was audited by KPMG Services Proprietary Limited ("KPMG") and filed with the Constitutional Court ("Court") in the matter of *Allpay Consolidated Investment Holdings (Pty) Ltd and Others v Chief Executive Officer of the South African Social Security Agency and Others* 2014 (4) SA 179 (CC) ("Allpay 2").

3. The Allpay matter before the Constitutional Court dealt with the challenge to government's award of the tender to distribute social grants nationally to Cash Paymaster Services. The tender was declared unlawful and invalid but this order was suspended in order to ensure the continued payment of social grants unless or until the South African Social Security Agency ("SASSA") could implement a new lawful provider or until the end of the contract period ending 31 March 2017. The Court ordered at paragraph 78.4.2 in Allpay 2, "*Cash Paymaster must file with this Court an audited statement of the expenses incurred, the income received and the net profit earned under the completed contract*".

[1] This report was prepared by Dick Forslund, a senior economist at AIDC.

4. This report seeks to critically examine the Statement filed by CPS.

5. An analysis into the Statement cannot be undertaken without viewing it in the context of the Allpay 2 judgment. We have viewed paragraph 67 as the point of reference for this report. Here, the Court says that the invalidation of the contract "*should not result in any loss to Cash Paymaster*", but also that CPS, "*has no right to benefit from an unlawful contract*", that "*any benefit that it may derive should not be beyond public scrutiny*". The Court concludes that the solution is "relatively simple"; CPS:

> "*can provide the financial information to show when the break-even point arrived, or will arrive, and at which point it started making a profit in terms of the unlawful contract*".

6. Beyond the Statement filed by CPS and the Allpay 2 judgment, we have used the 2012 – 2017 Annual Reports published by CPS' parent company Net1 UEPS Technologies Inc ("Net1") which is registered in the United States and the judgment of the Court in the 2017 matter of *Black Sash Trust and Another v Minister of Social Development and Others* 2017 (3) SA 335 (CC) ("Black Sash Judgment") as a means of analysis. In addition, we have consulted an organogram of the Net1 group of companies dated 30 June 2016 (see "**Annexure 2**"). Other supporting sources are cited in footnotes.

Concerns with CPS' statement and summary of conclusions

7. This report identifies a number of concerns with CPS' statement. These are explained below and highlighted here in a summary of the conclusions:

    7.1. The Statement does not clarify which of the South African entities owned by Net1 — and its South African subsidiary Net1 Applied Technologies South Africa (Pty) Ltd ("Net1 SA") — it covers. As CPS failed to clarify this in their reporting to the Constitutional Court, the independent auditor KPMG ought to have done so.

7.2. It appears in the Notes to the Statement[2] that least one of the two broad-based black economic empowerment ("BEE") transactions has been added to CPS' "Expenses Incurred" line item. What is concerning is that these transactions were fictitious book entry expenses based on predictions of Net1's financial future, but also that the fictitious value of such BEE transactions hardly appears in the books of CPS but rather in the books of Net1 (CPS' parent company in the US) or possibly Net1 SA, where they are recorded as expenses.

7.3. Net1's Annual Reports (which are audited by Deloitte & Touche) inform the shareholders how large a percentage share of Net1's total revenue they every year ascribe to "*CPS' social welfare grant distribution business*".[3] A simple analysis of this data shows that the revenue from the grant distribution business as reported in the Net1 Annual Reports has been about R455 million higher over the contract period (of five years) than the "Income Received" reported by CPS to the Court. There is no explanation as to why this is the case.

The identity of the Third Respondent and the ambit of the Statement

8. We refer to an organogram of CPS within the Net1 group structure, dated 30 June 2016 ("2016 Organogram"). Net1 is a transnational enterprise. The organogram features 60 companies. Twenty-three of them are registered in South Africa.[4] The organogram is attached as "**Annexure 2"**.

9. Formally speaking, 'CPS' would refer to the company registered at the Commercial and Intellectual Property Commission ("CIPC") with number

[2] 'Notes to the Audited Statement of the Expenses Incurred, the Income Received and the Net Profit Earned under the Contract for the period ended 31 March 2017' included in the Statement filed by CPS.
[3] Net1, 2016 Annual Report, page 8.
[4] An organogram is accessible from http://www.net1.com/media/65388/group_structure_march_2017.pdf. This is a later amended organogram that replaced the 2016 organogram in March 2017.

1971/007195/07. Here it is reflected that CPS is engaged in "*financial intermediation insurance, real estate and business services*". The 2016 Organogram shows that this firm controls five subsidiaries.

10. Three of the subsidiaries that are wholly owned by CPS are also in the business of social grants distribution.[5] According to the 2016 organogram (**Annexure 2**), there are also two security companies which may have been engaged in protecting cash distribution of social grants at pay points. Siyeza Security Services (Pty) Ltd ("Siyeza") is wholly owned by CPS and Sinqobile Security Services (Gauteng) (Pty) Ltd is wholly owned by Siyeza (**Annexure 2**).[6]

11. The CIPC registry confirms that 'Cash Paymaster Services (Kwa-Zulu Natal)', 'Cash Paymaster Services (North West)' and 'Cash Paymaster Services (Northern)' are in business as at 5 July 2017 and they are in the 2016 Organogram. Screen shot 1 below illustrates that there are ten companies in total registered with the name 'Cash Paymaster Services';[7] the six companies at the top of the CIPC list were deregistered in 2010 and 2011; the remaining four are currently in business.

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[5] Two of them have their business described in the same wording as their owner CPS. "CPS North West" is described as engaged in "*wholesale and retail trade; repair of motor vehicles, motor cycles and personal and household goods; hotels and restaurants*". Anomalies like this are common in the CIPC registry.

[6] The two security companies don't appear in a second organogram dated 30 June 2017, accessible from http://www.net1.com/media/65388/group_structure_march_2017.pdf. Siyeza Security Services went into final deregistration in 2015. There is a Sinqobile Security Services in conversion from Company to Closed Company in the CIPC registry.

[7] Accessed via WinDeed on 5 July 2017.

10 match(es) found for the criteria specified.

Date requested	2017/07/05 19:13
Company name	CASH PAYMASTER
Filter applied	STARTS WITH

Select one or more list items to search.

Company Name	Registration Number
CASH PAYMASTER SERVICES (FREE STATE)	M2001/024341/07
CASH PAYMASTER SERVICES (MPUMALANGA)	M1996/011273/07
CASH PAYMASTER SERVICES (GAUTENG)	M1996/016435/07
CASH PAYMASTER SERVICES (EASTERN CAPE)	M1998/000033/07
CASH PAYMASTER SERVICES (WESTERN CAPE)	M1994/001324/07
CASH PAYMASTER SERVICES (NORTHERN CAPE)	M1997/013358/07
CASH PAYMASTER SERVICES	M1971/007195/07
CASH PAYMASTER SERVICES (KWAZULU NATAL)	M1997/013382/07
CASH PAYMASTER SERVICES (NORTHWEST)	M1996/011197/07
CASH PAYMASTER SERVICES (NORTHERN)	M1996/017600/07

Screen shot 1

12. In CPS' Statement to the Court, KPMG addresses their Independent Auditor's Report to "*the directors of Cash Paymaster Services Proprietary Limited ('the Company')*". This suggests that "*the incomes, expenses incurred, the income received and the net profit earned under the contract*" only refers to CPS with registration number 1971/007195/07.

13. It is also possible that the Statement is a consolidated statement.[8] If that is the case, and CPS' Statement to the Court includes expenses, incomes and net profits "under the contract" of the other three companies (or five companies, if the two security companies are included) in the group of companies controlled by CPS, then this should have been mentioned in the Notes to the Statement, but it is not.

14. In summary, and disregarding the critical discussion below on so called 'vertical integration' as well as the inclusion of certain expenses in the Statement, there are three distinct possibilities for which entities have been operating "*under the contract*":

[8] In a group of transacting firms the income of one is the expense of the other and cancels each other out. If they are owned by a controlling company, the standard procedure is to also report about the group's income, expenses and profit as if they are all one company engaging as such with "the outside world". This is called a consolidated statement.

14.1. the first is where only one entity operated under the contract i.e. Cash Paymaster Services (Pty) Ltd;

14.2. the second is where four entities operated under the contract i.e. Cash Paymaster Services (Pty) Ltd as well as its three subsidiaries Cash Paymaster Services (Kwa-Zulu Natal), Cash Paymaster Services (North West), and Cash Paymaster Services (Northern); and

14.3. the third is where six entities operated under the contract i.e. Cash Paymaster Services (Pty) Ltd as well as its subsidiaries Cash Paymaster Services (Kwa-Zulu Natal), Cash Paymaster Services (North West), Cash Paymaster Services (Northern) and the two security companies mentioned above.

15. The primary concern here is that neither CPS nor KPMG have made these distinctions. This requires clarification.

BEE Transactions and the expenses of CPS

16. There are three issues of concern with the treatment of the BEE transaction in the Statement.

17. The first concern relates to the costing of the BEE transaction. While very little detail is given on the issue of the entity to which the Statement relates, the contrary is true in relation to the BEE deal.[9] The Court is informed how *"[t]he value of the empowerment transaction*" was calculated, by quoting verbatim some of the explanation made in Net1's 2014 Annual Report. It is from the 2014 Annual Report that phrases like "*utilising an adjusted Monte Carlo simulation*" or "*the 'adjustment' to the Monte Carlo simulation model incorporates a 'jump diffusion' process to the standard Geometric Brownian Motion simulation*" are derived.[10]

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[9] Net1, 2014 AR, page F34 informs that the BBEE partner bought shares at a 25% rebate (compared to the market price at the time). The purchase was financed by a five year interest bearing loan from Net1.

[10] Net1, 2014 AR, page F36. An online dictionary explains that a Brownian Motion is "*the erratic random movement of microscopic particles in a fluid, as a result of continuous bombardment from molecules of the*

18. Despite the elaboration on the method of calculation for the BEE transaction, CPS does not report to the Court the value at which this transaction has been taken up as a CPS 'expense'. Net1's 2014 Annual Report records however that the value taken into the books of Net1 was US$ 11 268 000.[11] This is R117 148 889 at the exchange rate R10.3966 per US$, used by Net1 for income and expenses in its 2014 Annual Report.[12]

19. CPS might have used another exchange rate, such as from the date/s when the transaction/s was/were made. For our calculations below, we use a R117.1 million estimate.

20. The second concern in relation to the BEE transaction is the fact that *"[t]his was a book entry and no cash was actually paid. The charge recorded was determined as the difference between the fair value of the loans provided to the BEE partners and the fair value of the equity instruments granted to the BEE partners*".[13] The 'fair value' of the equity instruments was based on a prediction of the future values of these instruments (with methods borrowed from natural science).

21. A third concern is that, aside of the fictitious character of this expense, it cannot be taken up as a cost in CPS' accounts; it should instead be in the accounts of the seller of shares. Changes in ownership of CPS shares are not an expense to CPS. Thus, if the BEE transaction is regarded as expense, it seems it was an expense to Net1 SA, as depicted in the 30 June 2016

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surrounding medium". This illustrates how mainstream Finance theory draws upon natural science to predict the future in order to arrive at a valuation in the present of, for example, shares traded on the stock market

[11] Net1, 2014 AR, table on page 9.

[12] Net1, 2014 AR, page 38.

[13] Net1, 2014 AR, page F36. The Annual Report refers to "cash flows" that are imaginary. "The charge related to the equity instruments issued pursuant to the BEE transactions was determined to be approximately $11.3 million and was expensed in full during the year ended June 30, 2014, because the BEE partners owned the shares on the issue date. […]The fair value of the loans provided to the BEE partners was determined to be their face value. The fair value of the equity instruments was calculated utilizing an adjusted Monte Carlo simulation discounted cash flow model which was developed for the purpose of the valuation of these BEE transactions. Cash flows were calculated for each simulated share price path, taking into account the bespoke features of the BEE transactions, as well as the expected interest and capital repayments (funded through the expected sales of BEE shares [sic])."

organogram ("**Annexure 2**"). [14] The transaction reduced Net1 SA's ownership of CPS to 87.5%.[15]

22. Net1 declares that—

> "*[d]uring 2014, we executed our BEE transactions that initially had Net1 issuing 4.4 million shares to our BEE partners. As a result of various trigger events and due to a number of related subsequent transactions, our BEE partners now hold just under 1% of the Company's common stock and 12.5% of our CPS business*."[16]

This indicates that if the loss of one percent shareholding in the parent company Net1 (i.e. the company registered in the US) was an expense to anyone, it was an expense to those who parted with some of their shares in Net1 or got their shareholding diluted by the BEE transaction. Second, and in the same vein, the transfer of ownership in CPS shares can only be recorded as an expense in the books of the entity that parted with those shares, which evidently was Net1 SA (the organogram in **Annexure 2** shows the 87.5% ownership of Net1 SA in CPS after the 2014 BEE transaction). Third, this begs the question: what relevance the "Brownian Motion" method of share valuation has for the shares of CPS that are not traded on the stock exchange? For CPS shares, there is no need to use methods borrowed from physics to "capture the discontinuous share price jumps observed in the Company's share price movements on stock exchanges on which it is listed".[17] The long Note 14 in Net1's 2014 AR shows that it was not CPS itself that parted from a 1% share in Net1. New shares were issued.[18]

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[14] The seller got an interest bearing claim for the shares (the loan to the BEE partner). It amounted to 75% of the market value of the shares. According to Net1's 2014 AR, "The loans bore interest at a rate equal to the Johannesburg Interbank Rate plus 300 basis points". If the share price would fall by more than 25%, the loan might become more worth than the shares at the time of the sale. The 'non-cash expense' would then reveal its fictitious character more clearly. Here the loan instead fell into arrears, triggering new measures. This does not matter. The "Brownian Motion" and "Monte Carlo" modelling book entry does not belong in the books of CPS.
[15] The organogram shows that Net1 SA was the party in the BEE transaction.
[16] Net1, 2014 AR, page 2.
[17] Net1, 2014 AR, page F36.
[18] Net1, 2014 AR, page F34.

23. On 19 April 2012, there was also an initial "*BEE equity instruments charge*" of US$ 14 211 000 (the contract period started 1 April 2012).[19] At that point, the rand-dollar exchange rate stood at 7.7186 (used for incomes and expenses in Net1's 2012 AR). This 'non-cash charge' was equivalent to R109 689 025.

24. This charge reflected an option for BEE partners to buy 'common stock' (i.e. not in CPS) at a fixed price. The option was never used, because:

> *"our stock price decreased materially when we announced the existence of the DOJ and SEC investigations and the option expired unexercised on April 19, 2013, as our stock price continued to remain substantially below the exercise price of the option through the expiration date of the option"*.[20]

25. This further underlines the fictitious character of a book entry expense based on probing into the future. However, the Generally Accepted Accounting Rules (GAAP) used in the US "*[do] not permit the reversal of the prior charge*" as Net1 informs its shareholders.[21] This stayed in the accounts as a 2012 financial year expense as it had been registered, even if the option to buy and the "cost" for this to Net1 was never realised.

26. The same rule of non-reversal should apply to the 2014 BEE transaction, which ostensibly forms part of CPS' Statement to the Court.

27. The value of the 2012 option was calculated using what is called the 'Cox Ross Rubinstein binomial model'.[22] It is not mentioned in the Notes of the Statement under sub-headline 'Charge for empowerment transaction'. It appears that CPS erroneously also did not include this amount of

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[19] Net1, 2014 AR, page 9 (according to pdf file; this part of the AR is not paginated): Table under sub-headline "Reconciliation of GAAP net income to fundamental income".
[20] Net1, 2013 AR, page 22.
[21] Ibid. at page 23.
[22] Net1, 2014 AR, page F36.

approximately R109.7 million in CPS' expenses. The Notes speak of one transaction without giving the year and the amount:

> "*The Statement is prepared on the historical cost basis, with the exception of the charge for the empowerment transaction which is recognised at fair value as described below*," (emphasis added).

28. The Statement does not indicate if it is referring to the R117.1 million 2014 BEE transaction or the 2012 BEE transaction that was never realised. If the Statement includes the 2012 "non-cash charge" BEE transaction it must of course also be subtracted from expenses.

29. Either way, neither of the two BEE transactions can be recorded as an expense in the books of CPS.

Net1's social grant business viewed in context

30. The Notes to Statement under sub-heading 2 'Basis of Preparation of the Statement', indicates:

> "*The directors have interpreted the words 'under the contract' as relating directly to the SASSA contract and therefore income and expenses incidental to but not arising from the contract have been excluded from the Statement.*"

31. Firstly, this contradicts the erroneous inclusion of at least one BEE transaction as an expense of CPS (as argued above).

32. Secondly, in light of the Court's Allpay 2 judgment, it is not clear why the Statement should have such a narrow ambit and what this means. No examples of exclusions are given to illustrate how "*incidental to… the contract*" is defined.

33. Thirdly, as discussed below, it certainly appears from Net1's Annual Reports that incomes and expenses 'incidental' to the SASSA contract

ought to be approximated in order to get a more accurate estimate of the financial benefits that accrue to Net1 SA's (and the mother company Net1 as well as other SA subsidiaries) from the constitutionally invalid SASSA contract.

34. And, finally, CPS is controlled by Net1 SA which is controlled by Net1. CPS could not sign the SASSA contract without the approval of Net1. Aside from the legal consideration that one single company signed the contract, we repeat that Net1's Annual Reports show that incomes and expenses 'incidental' to the SASSA contract ought to be approximated.

35. Net1 has integrated the public social grants system with financial service businesses of its other South African subsidiaries. This is why Net1 can speak of "*our social welfare grant customers*" in South Africa. It states, for instance, that:

> *"The UEPS/EMV technology has been deployed on an extensive scale in South Africa through the issuance of MasterCard-branded UEPS/EMV cards to our social welfare grant customers."*[23]

36. Net1's 2014 Annual Report reads:

> "*We believe that our large cardholder base, specialized technology and payment infrastructure, together with our strong government and business relationships, position us at the epicentre of commerce in the country*."[24]

37. This raises the question about whether the businesses of several of Net1 SA's subsidiaries would at all be profitable or how profitable they would be without access to the social grant beneficiaries. Net1's 2014 Annual Report states:

[23] Net1, 2014, page 2.
[24] Net1, 2014, page 5.

"As a result of the South African government's focus on the provision of social grants as a core element of its social assistance and poverty alleviation policies, and our SASSA contract to distribute such grants on a national basis, we believe that we are in a position to provide services to over 50% of the country's adult population,"[25] (emphasis added).

38. In addition to this, Net1 stated in a media communication of May 2015 that it would continue:

> *"providing a comprehensive suite of transactional products and services, [which] will allow it to service all South Africa's unbanked and under-banked citizens including social grant beneficiaries, but independently and without SASSA's limitations and constraint. The Company's business plan includes the continued successful deployment of its EasyPay Everywhere bank account."*[26]

39. It appears these 'transactional products and services' refer to the services provided by Net1 subsidiaries other than CPS. This contention finds support in the 2015 Annual Report, wherein Net1 states that:

> *"For us, financial inclusion is more than being able to open a bank account. . . . Our differentiator is our technology, security and business models, which interprets information to facilitate eligibility and lower inherent risk. . . . As a result, we now offer savings accounts, microfinance, insurance, prepaid services, money transfers, loyalty programs, educational services, healthcare, and mobile and e-commerce payments - to name but a few."*[27]

40. The "lower inherent risk" comes with the possibility of deductions from the social grants when they are paid out. This may be especially important for

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[25] Ibid.
[26] Net1*, Net1 Elects to Withdraw from SASSA RFP 18 May 2015*, available at http://media.corporateir.net/media_files/IROL/73/73876/Net1%20Elects%20to%20Withdraw%20from%20SASSA%20RFP.pdf .
[27] Net1, 2015 Annual Report, page 1.

the viability of Net1 SA's micro-loan business. In this regard, CPS stated the following in its tender proposal:

> "*We created the <u>automatic debit feature to allow a smart card to reduce the balance in any of its active wallets on a specific date and for a predetermined amount</u>. This function can take place in an offline environment at any POS device. The automatic debit feature <u>reduces the risks associated with collection of insurance premiums and other regularly scheduled payments by ensuring that any funds loaded to the smart card are first used to service the automatic debit before being transferred for the card holder's general use</u>.*
>
> *The participants in an automatic debit transaction are the automatic debit initiator, the merchant and the smart card holder. The automatic debit initiator is the issuer which will create an automatic debit instruction for a particular wallet of a specific smart card holder. <u>The merchant is any retailer which is a participant in the system and has a [UEPS] POS device for a card holder to activate automatic debit instructions</u>. The card holder is the person who must pay the premium or other payment*," (emphasis added).[28]

41. The provision of these services is made possible through the sharing of the technology to read the confidential data of social grant beneficiaries which is contained on the universal electronic payment system ("UEPS") enabled SASSA-branded bank cards. It seems that it is this card technology that makes possible the so called vertical integration of Net1 SA's subsidiaries possible. Net1's 2015 Annual Report states:

> *"Looking forward to 2016, we now operate our business across three primary 'verticals':*
>
> - *Card-centric solutions, which are driven by our UEPS/EMV biometric smart card technology such as EPE* [Easy Pay

[28] CPS Technical Proposal Management Summary date stamped 27 June 2011.

Everywhere], *World Food Program ("WFP"), MasterCard and SASSA;*

- *Mobile-centric solutions, which focus on the deployment of our various mobile products such as Mobile Virtual Card ("MVC"), Variable-PIN ("VPIN"), and value-added services; and*
- *Transaction Processing, which includes our KSNET, EasyPay, and FIHRST switches.*

These verticals are capable of operating independently of one another but frequently supplement one or more of the other verticals. More importantly, each vertical has a specific set of opportunities and go-to-market strategy."[29]

42. For the above reasons, financial statements of Net1 subsidiaries, other than CPS, are relevant for an accurate and comprehensive assessment of the total financial benefits to Net1 SA and its parent company Net1 from the constitutionally invalid SASSA contract during its period of five years. The most notable subsidiaries are: Prism Holdings with its subsidiary EasyPay (Pty) Ltd, Net1 Finance Holdings with its subsidiary Moneyline Financial Services (Pty) Ltd, Manje Mobile Electronic Payment Services (Pty) Ltd, Finbond Group Limited and The Smart Life Insurance Company Limited.

A critical account for the five year SASSA contract period

43. What follows examines what all Net1 Annual Reports record to shareholders about the revenues from "*CPS' social welfare grant distribution business*". We compare this information to the declaration of income in CPS' Statement to the Constitutional Court.

44. In the 2014 Annual Report, Net1 reports the following to its shareholders:

"*Our CPS business unit is based in Johannesburg, South Africa, and deploys our UEPS/EMV–Social Grant Distribution technology to distribute social welfare grants on a monthly basis to over nine*

[29] Net1, 2015 Annual Report, page 1.

million recipient cardholders in South Africa. These social welfare grants are distributed on behalf of the South African Social Security Agency, or SASSA. ***.*** *During our 2014, 2013 and 2012 fiscal years, we derived approximately 27%, 42%, and 41% of our revenues respectively, from CPS' social welfare grant distribution business."*[30]

45. In the 2016 Annual Report, Net1 states that:

> "*During our 2016, 2015 and 2014 fiscal years, we derived approximately 21%, 24%, and 27% of our revenues respectively, from CPS' social welfare grant distribution business."*[31]

46. Similarly, the 2017 Annual Report states that:

> *"During our 2017, 2016 and 2015 fiscal years, we derived approximately 22%, 21%, and 24% of our revenues respectively, from CPS' social welfare grant distribution business."*[32]

47. Thus, the percentages given for the annual revenues harvested by "CPS' social welfare grant distribution business" are percentage share of the total consolidated annual revenues of the whole Net1 group that comprises about 60 companies.

48. Data over the total annual revenue is published in Net1's Annual Reports which also state the US$/R exchange rates used for each financial year (Net1's financial year ends 30 June). What appears below is a table of Net1's consolidated revenue and the revenues harvested by "CPS' social welfare grant distribution business" at 100% from 2012 to 2016 and at 75% in the 2017 financial year (as the five year contract ended three months

[30] Net1, 2014 Annual Report, page 6.
[31] Net1, 2016 Annual Report, page 8.
[32] Net1, 2017 AR, page 9. "Our revenue" is the consolidated revenue of the whole Net1 group: 'All references to "the Company," "we," "us," or "our" are references to Net1 UEPS Technologies, Inc. and its consolidated subsidiaries, collectively…' (Net1, 2016 AR, page 3).

prior to the end of their 2017 financial year).[33] Table 1 below compares CPS' stated 'income received' in the Statement with what the Net1 Annual Reports from 2012 to 2017 report on the revenue from "CPS' social welfare grant distribution business".

REVENUES (Net1 AR data)	2012	2013	2014	2015	2016	2017 (3Q)
South Africa in US$ 000'	272 063	317 916	428 931	461 425	422 022	325 601
Total Net1 US$ 000'	**390 264**	**452 147**	**581 656**	**625 979**	**590 749**	**457550**
SA share of total revenue	69,7%	70,3%	73,7%	73,7%	71,4%	71,2%
ZAR per US$ (Net1 ARs)	***7,7186***	***8,7105***	***10,3966***	***11,4275***	***14,3842***	***13,6182***
Net1 total revenue in ZAR	**R 3 012 291 710**	**R 3 938 426 444**	**R 6 047 244 770**	**R 7 153 375 023**	**R 8 497 451 766**	**R 6 231 000 601**
"CPS share of total Net1"	***41%***	***42%***	***27%***	***24%***	***21%***	***22%***
CPS revenue US$ 000'	*160 008*	*189 902*	*157 047*	*150 235*	*124 057*	*100 661*
CPS's share of SA revenue	58,8%	59,7%	36,6%	32,6%	29,4%	30,9%
Net1: CPS revenue ZAR	**R 1 235 039 601**	**R 1 654 139 106**	**R 1 632 756 088**	**R 1 716 810 005**	**R 1 784 464 871**	**R 1 370 820 132**
	TOTAL CPS REVENUE	*STATEMENT to ConCourt: "INCOME RECEIVED":*			*Difference*	
	R 9 394 029 804		**R 8 938 509 720**		**R 455 520 084**	

Table 1

49. The South African revenue share of Net1's total consolidated revenue has been stable at around 70%. In contrast, the revenue from CPS' social grant distribution business as a share of revenue in South Africa fell drastically in the third year of the contract period and continued to fall after that. In our view, this indicates when the 'vertical integration' between CPS and the businesses of Net1's other subsidiaries started to have effect.

The terms "Income received" and "Revenue"

50. CPS' Statement uses the term 'income received', which is the same as the term used by the Court in paragraph 78.4.2 of Allpay. We interpret both terms to mean 'revenue'.

51. The Court required an account of CPS' "*income received under the completed contract*". The term 'income' at times equates to revenue minus

[33] The SASSA contract ended on 31 March 2017 which was 9 months into the 2017 financial year 75% of the 2017 financial year revenues are therefore used in Table 1, because 9 months is 75% of 12 months.

taxes and expenses, i.e. basically 'profit after tax', but this is not the meaning of 'income' in this case. If CPS and KPMG meant something more by the term 'income received' (for instance, if including interest on loans in the 'income received') then the R455 million difference in Table 1 above, between revenue from "CPS' social grants distribution business" in Net1's Annual Reports and the revenue included in the Statement, would be even bigger. The Notes indicate that depreciation, cost of sales or write down of inventories have been included in the expenses. We take for granted that there is no large 'negative income' deducted from the Statement's 'income received' and that it does not show a 'net' income after deductions other than small and simple transaction costs. Otherwise, this should have been pointed out in the Notes to the Statement. The concept 'revenue' is used in the Notes to the Statement, but this is changed to 'income received' in the part of the Statement that contains numerals.

52. To avoid confusion, the Notes to the Statement should have contained an indication of how the Court's order to report on 'income received' was interpreted when compiling the Statement. For reasons given above, we have assumed that CPS means 'revenue', but used the wording of the court order.

Adjustments of pre-tax profit, based in Net1's revenue reports

53. CPS reports a revenue of R8 938 509 720 to the Court for the duration of the contract. This is around R455 million lower than the revenue reported to Net1 shareholders (which is R9 394 029 804); the figure is easily derived from the data in Net1's Annual Reports (Table 1). It appears Net1 calculated revenue received 'under' the SASSA contract very differently when reporting to its shareholders compared to how CPS calculated 'income received' when reporting to the Court.

54. To make an alternative estimate of pre-tax profit, we use two methods using the higher revenue estimates stated in Net1 Annual Reports (calculated to R455.1 million), which are 5.1% higher than in the Statement. For the minimum estimate of profit before tax, we also increase expenses

by 5.1%. This increases expenses to R8 247million. The pre-tax profit becomes R1 147million.[34] An illustration of this calculation appears below:

R9 394 029 804 (5.1% higher Revenue in line with Net1's ARs)
- R8 247 018 765 (Expenses, also increased by 5.1%)
= R1 147 011 039 (Net profit before tax)

R8 247million (being the expenses increased by 5.1%) is R400.2 million more than the Expenses reported in the Statement to the Court (i.e. R7 846 843 217).

55. Expenditure rises at the same rate as the higher revenues reported in Net1's Annual Reports, keeping the pre-tax profit margin to what it is in the Statement.[35] Pre-tax net profit becomes **R1 147million**. This is **R55.3million** more than in the Statement (**R1 091.7million**).

56. For a maximum alternative estimate of pre-tax profit we instead use what the Statement says to the Court about the 'expenses incurred'. If we simply subtract them from the revenue reported by Net1 for the "social welfare grant distributing business" (as calculated in the table above) we get **R455.5 million** more in pre-tax profit during the contract period (i.e. **R1 547.2 million** instead of **R1 091.7million** in the Statement).

57. This suggests that, in the first step of an alternative account, CPS' pre-tax profit should be reported at between **R55.3million** and **R455.5million** more than what was reported in the Statement. This is before other possible corrections.

58. We argued above that the 2014 BEE transaction should be excluded from expenses in the Statement. Doing so further increases profit before tax by an estimated **R117.1 million**. When this is added to the two estimates in

[34] The profit margin will be 12.21% just as it is in the Statement, because we increase expenses and revenue by the same 5.1% rate.

[35] We have cautiously assumed "constant economics of scale". It is likely that expenditures increase at a slower rate than revenue, which would result in a higher profit than in our minimum alternative estimate.

the paragraph above, the correction upwards of net pre-tax profit will be between **R172.4 million** and **R572.6 million**. If the 2012 BEE transaction were also included in the Statement, it too ought to be subtracted from the expenses. Profit before tax in the Statement would then increase by another estimated R109.7 million. For reasons explained above, we assume that it was not included.

59. Net1's 2014 Annual Report further reports that **R41.8 million** in cash bonuses "*related to our SASSA tender award*"[36] were paid to senior managers. The question of whose incomes and expenses are included in the Statement to the Court applies here as well. The Notes to the Statement indicate that this reward might be included in the Statement where it provides:

> "*When there is a present legal or constructive obligation to make a bonus payment as a result of a past event and a reliable estimate of the obligation can be made, it is recognised as an expense*".[37]

60. First, if the **R41.8million** were included as expenses "under the contract", they should be deducted from expenses. Cash bonus payments to chief executive officers and senior managers are controlled by the majority shareholders. They are profits distributed in another form.

61. Second, even if they have not been taken up as expenses in the Statement, but appear only in the books of the parent company in the US, they were paid as a reward for a constitutionally invalid SASSA contract. CPS is their source. It can, therefore, be argued that the **R41.8 million** must be added to profit before taxation in the Statement.

[36] Net1, 2014 AR, page 44: US$5.4mn. The amount is also given in ZAR. We use that number as it is.

[37] The Notes to the Statement do not disclose if the large SASSA-related bonus payment was included in expenses. That it is can however be interpreted from the remark on "Constructive obligation" in the Notes. The term means that employees had good reasons to expect a bonus; for example because a promise had been made. See the Circular: "International Accounting Standard 37" accessible at: http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias37_en.pdf .

62. The upward adjustment of the pre-tax profit compared to the Statement then lands between **R214.2 million** and **R614.4 million**. The higher adjustment would lead to a pre-tax margin of 18.2% (**R1 706 million** (profit) ÷ **R9 394 million** (revenue) = 0.182), the lower adjustment by **R214.2 million** to a margin of 13.9%, compared to the 12.2% margin in the Statement.[38]

63. It is evident from Net1's Annual Reports and other sources quoted above, that other South African subsidiaries have benefitted from the SASSA contract which has been declared constitutionally invalid. This is the 'vertical integration' aspect of Net1's business.

64. If a Net1 SA subsidiary outside the CPS group (in any way) had access to social grant beneficiaries' confidential data as a precondition for doing profitable business or harvested extra profits because of such access, it can well be argued that these profits too would be subject to paragraph 78.4.2 of the Allpay judgement. In other words, it would be subject to the disclosure of expenses incurred, income received and net profit earned "under the completed contract". This cannot be established without access to the financial reports of the South African subsidiaries.

Conclusion

65. Based on the above, in our view CPS has provided insufficient information for the Court to draw a definite conclusion about how much CPS (and its fellow companies in South Africa) profited from the SASSA contract. In order to be fully transparent, CPS ought to make the following available to the Court and the public, and ought to explain:

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[38] If we exclude the "Administrative cost" from total "Expenses incurred" we get an "operational margin" in the Statement at about 22.1% (R1 980.2mn/R8 938.5mn=0.221). Admin expenses are 11.3% of total expenses. If we use this 11.3% cost relation for our two profit adjustment alternatives we get a span between 22.1% and 27.4% in operational margin. It is not clear why total revenue harvested by "*CPS' social welfare grant distribution business*" is R455 million higher in Net1's Annual Reports, but it is possible that different approaches also affect "expenses incurred". That was one reason for giving a range between R214.2 million and R614.4 million in suggested upward correction of pre-tax profit. Our worksheet for all calculations is available.

65.1. Annual financial statements of CPS (Pty) Ltd with registration number 1971/007195/07 for the financial years 2012 to 2016 that should include CPS' subsidiaries in a consolidated manner in a separate column. Such statements might already have been filed with the South African Revenue Services ("SARS") for tax purposes. The last nine months of the contract period can be accounted for separately.

65.2. The Constitutional Court in paragraph 67 of its Allpay judgment states that CPS "can provide the financial information to show when the break-even point arrived, or will arrive, and at which point it started making a profit in terms of the unlawful contract". Other problems aside, the Statement does not show how the grant distribution business progressed over time.[39]

65.3. A disaggregation of the expenses over a certain amount – we suggest R30 million — that were included in the two line items 'Operational Cost' and 'Administrative Cost' in the Statement to the Court.

65.4. A similar differentiation of the line item 'Income received'.

65.5. A list of the companies in the Net1 group that contributed to Income received and Expenses incurred in the submitted Statement along with the service they provide and the income they received and expenses incurred under or as an incidental result of the contract.

65.6. To examine how much or if Net1 SA and its 22 SA subsidiaries have profited from the SASSA contract, their relation to social grant beneficiary data should be clarified. Obvious candidates were mentioned above.

[39] For example, Table 1 attempts to do so using Net1's Annual Reports.

65.7. The financial statements of the holding company Net1 SA and its related party transactions are also pertinent. They, for example, might include management fees. This is one traditional way of channelling profits from a subsidiary to a mother company. In the books of CPS (Pty) Ltd such transactions become listed as 'expenses'.

Annexure 1

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Independent Auditor's Report

To the Directors of Cash Paymaster Services Proprietary Limited ("the Company")

Opinion

We have audited the statement of the expenses incurred, the income received and the net profit earned ("the Statement") under the South African Social Security Agency ("SASSA") contract dated 3 February 2012 ("the contract") for the period beginning 01 April 2012 to the period ended 31 March 2017, and notes to the Statement.

In our opinion, the Statement has been prepared, in all material respects, in accordance with the basis of preparation set out in the notes to the Statement.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Statement* section of our report. We are independent of the Company in accordance with the Independent Regulatory Board for Auditors *Code of Professional Conduct for Registered Auditors (IRBA Code)* and other independence requirements applicable to performing audits of financial statements in South Africa. We have fulfilled our other ethical responsibilities in accordance with the IRBA Code and in accordance with other ethical requirements applicable to performing audits in South Africa. The IRBA Code is consistent with the International Ethics Standards Board for Accountants *Code of Ethics for Professional Accountants* (Parts A and B). We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter – Basis of Preparation and Restriction on Use

We draw attention to the notes to the Statement, which describe the basis of preparation. The Statement has been prepared to assist the Company to provide information to the Constitutional Court as required in terms the Constitutional Court judgment handed down on 17 April 2014 in the case of *Allpay Consolidated Investment Holdings (Pty) Ltd and others v Chief Executive Officer of the South African Social Security Agency and others [2013] 2 All SA 501 (SCA) (The Allpay Judgement).* These are not the Company's statutory financial statements which are prepared in accordance with International Financial Reporting Standards and the Companies Act of South Africa. Our report is intended solely for the Company and Constitutional Court and should not be used by parties other than the Company or the Constitutional Court. Our opinion is not modified in respect of this matter.

Responsibilities of Directors for the Statement

The directors are responsible for the preparation of the Statement in accordance with basis of preparation set out in the notes to the Statement, and for such internal control as the directors determine is necessary to enable the preparation of the Statement that is free from material misstatement, whether due to fraud or error.

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Auditor's Responsibilities for the Statement

Our objectives are to obtain reasonable assurance about whether the Statement is free from material misstatement whether do to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the Statement.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the Statement, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, and related disclosures made by management.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

KPMG Services Proprietary Limited

Per M Danckwerts
Director
Chartered Accountant (SA)
Registered Auditor
30 May 2017

SASSA Tender 01/11/BS

Audited Statement of Expenses Incurred, the Income Received and the Net Profit earned under the Contract

Income received	8 938 509 720
Expenses incurred	
Operational cost	6 958 330 609
Administration cost	888 512 608
	7 846 843 217
Net profit before tax	1 091 666 503
Taxation	386 344 019
Net profit after tax	705 322 484

KPMG

Notes to the Audited Statement of the Expenses Incurred, the Income Received and the Net Profit Earned under the Contract for the period ended 31 March 2017 ("Statement")

1. ***Purpose of the Statement***

The Statement has been prepared to provide information to the Constitutional Court as required in terms of the order handed down on 17 April 2014 which requires an audited statement of the expenses incurred, the income received and the net profit earned under the contract for the payment of social grants entered into by and between the South African Social Security Agency (SASSA) and Cash Paymaster Services Proprietary Limited (CPS). These are not the CPS statutory financial statements which are prepared in accordance with International Financial Reporting Standards and the Companies Act of South Africa.

2. ***Basis of Preparation of the Statement***

The Statement has been prepared in accordance with the recognition and measurement requirements of International Financial Reporting Standards applicable to the preparation of the Statement and the requirements of the contract for the payment of social grants entered into by and between SASSA and CPS. The Statement is prepared on the historical cost basis, with the exception of the charge for the empowerment transaction which is recognised at fair value as described below.

The presentation and functional currency is South African Rand (R) and amounts are rounded to the nearest R1.

The accounting policies were selected and applied consistently for similar transactions.

The directors have selected and applied the following significant accounting policies in the preparation of the Statement. The directors have interpreted the words "under the contract" as relating directly to the SASSA contract and therefore income and expenses incidental to but not arising from the contract have been excluded from the Statement.

Revenue

Revenue from the rendering of services is recognised when the amount of revenue can be measured reliably; it is probable that the economic benefits associated with the transaction will flow; the stage of completion of the transaction at the reporting date can be measured reliably and the cost incurred for the transaction and the costs to complete the transaction can be measured reliably.

Revenue from the sale of goods is recognised when the significant risks and rewards of ownership of the goods has transferred to the buyer; neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold are retained; the amount of revenue can be measured reliably; it is probable that the economic benefits associated with the transaction will flow to the entity and the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Revenue is measured at the fair value of the consideration received or receivable.

Depreciation

The depreciable amount of an asset is allocated on a systematic basis, using the straight line method, over its useful life as a depreciation charge to expenses. The depreciable amount is the cost of an asset less its residual value.

The cost of an asset comprises its purchase price, including import duties and non-refundable purchase taxes after deducting trade discounts and rebates and any cost directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended.

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The residual value of an asset is the estimated net amount that would currently be obtained from disposal of the asset as if the asset were already of the age and condition expected at the end of its useful life. The useful life of an asset is the period over which an asset is expected to be available for use or the number of units expected to be obtained from the asset. Each part of an asset with a cost that is significant in relation to the total cost of the item is depreciated separately.

Provisions
A provision is recognised when there is a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. Where the effect of the time value of money is material, the present value of the expenditure is used to recognise the provision.

Charge for empowerment transaction
The value of the empowerment transaction is measured by reference to the fair value of the equity instruments granted at the grant date. The grant date is when there is an agreement to a share-based payment arrangement. Vesting conditions, other than market conditions, are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Market conditions are taken into account when estimating the fair value of the equity instrument granted.

No subsequent adjustment to total equity is made after the vesting date to account for equity instruments that are forfeited or options that are not exercised.

The fair value of the equity instruments was calculated utilising an adjusted Monte Carlo simulation discounted cash flow model which was developed for the purpose of the valuation of these transactions. Cash flows were calculated for each simulated share price path, taking into account the bespoke features of the transactions, as well as the expected interest and capital repayments (funded through the expected sales of shares). The "adjustment" to the Monte Carlo simulation model incorporates a "jump diffusion" process to the standard Geometric Brownian Motion simulation, in order to capture the discontinuous share price jumps observed in the share price movements on the stock exchanges on which the shares are listed. Therefore, the simulated share price paths capture the idiosyncrasies of the observed share price movements. For each simulation, the resulting expected cash flows were discounted to the valuation date.

An expected volatility of 21.04%, an expected life of five years, a risk free rate of 7.90% and no future dividends were used in the calculation of the fair value of the equity instrument. The estimated expected volatility was calculated based on the 30 day VWAP share price using the exponentially weighted moving average of returns.

Leases
Operating leases are recognised by the lessee as an expense.

Operating lease expenses are recognised on a straight-line basis over the lease term.

Employee benefits
Short-term employee benefits paid in exchange for services rendered by employees during a reporting period are recognised as an expense.

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The cost of unused leave that has accumulated at the reporting date is recognised as an expense.

When there is a present legal or constructive obligation to make a bonus payment as a result of a past event and a reliable estimate of the obligation can be made, it is recognised as an expense.

When there is a present legal or constructive obligation and a demonstrable commitment to terminate the employment of employees before retirement, the expected cost of termination benefits is recognised as an expense.

Short-term employee benefits are recognised at the undiscounted amount.

Inventories and cost of sales
Inventories are measured at cost. Cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

The cost of inventories is assigned by using the weighted average cost formula.

After recognition, inventory is carried at its carrying amount, which is the lower of cost and net realisable value.

When inventories are sold, the carrying amount of those inventories is recognised as an expense in the period in which the related revenue is recognised.

The amount of any write-down of inventories to net realisable value and all losses of inventories are recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from the increase in net realisable value, is recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

Foreign currency transactions
A foreign currency transaction is recorded by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

Income tax
A deferred tax liability is recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from the initial recognition of goodwill or the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction affects neither accounting profit nor taxable profit.

A deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that is not a business combination and at the time of the transaction, affects neither accounting profit or taxable profit.

Current tax liabilities and assets for the current and prior periods are measured at the amount expected to be paid to or recovered from the taxation authorities, using the tax rates and tax laws that have been enacted or substantively enacted by the reporting period.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates and tax laws that have been enacted or substantively enacted by the reporting period.

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The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the company expects, at the reporting period, to recover or settle the carrying amount of its assets and liabilities.

Deferred tax assets and liabilities are not discounted.

Current and deferred tax are recognised as income or an expense and included in profit and loss for the period, except to the extent that the tax arises from a transaction or event which is recognised, in the same or different period, outside profit or loss, to other comprehensive income, directly to equity or arises from a business combination. These are recognised in other comprehensive income, directly in equity and goodwill, respectively.

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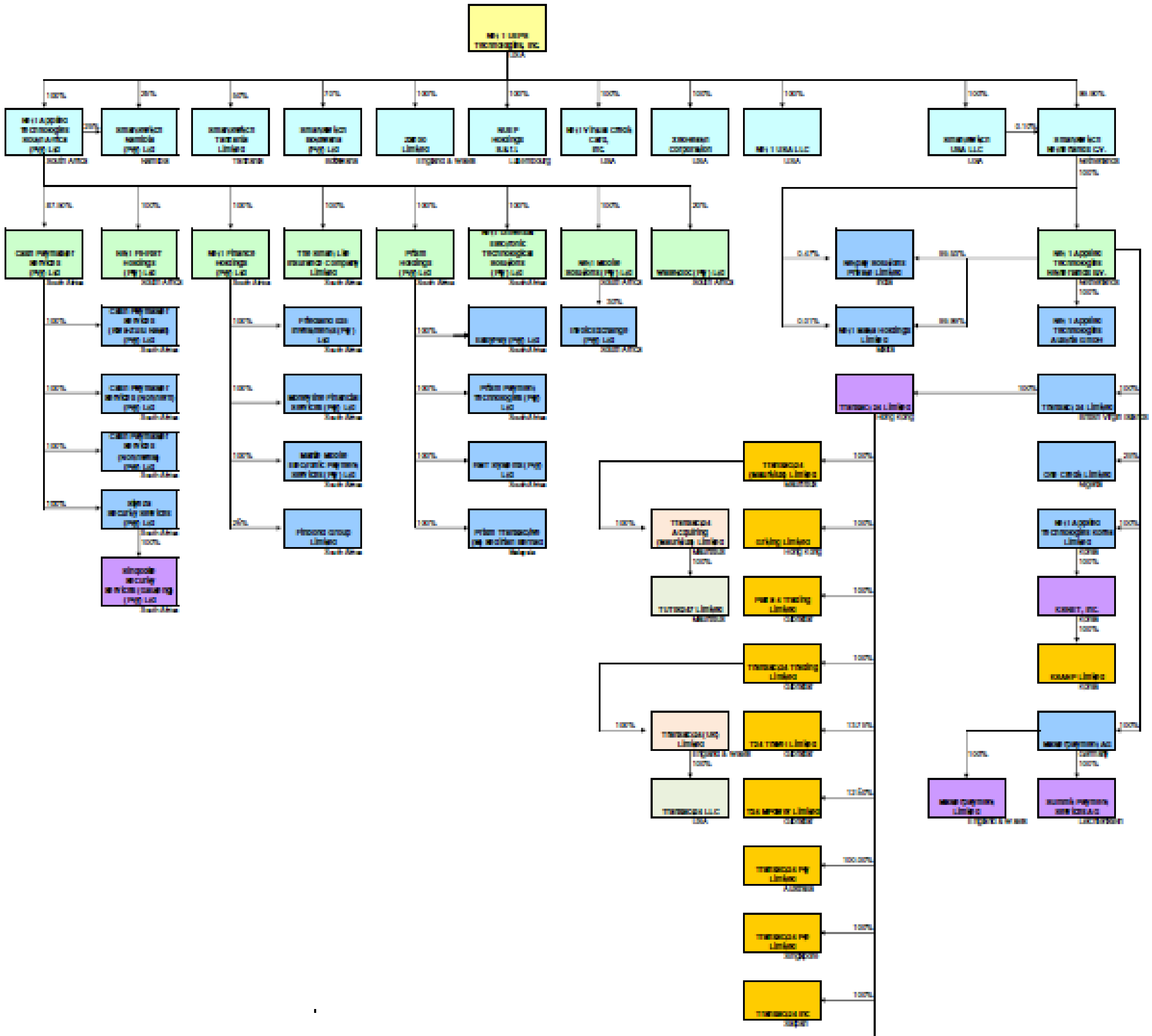
Annexure 2

Net 1 UEPS Technologies, Inc. Group



Above: Net1 organogram as at 30 June 2016.
Below: Detail from above organomgram. Cash Paymaster Services (Pty) Ltd is to the far left below.