PAYMENT DATA SYSTEMS INC
Form 10-Q
August 14, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2009.

or

o TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to ________.

Commission file number: 000-30152

PAYMENT DATA SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Nevada	98-0190072
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
12500 San Pedro, Ste. 120, San Antonio, TX	78216
(Address of principal executive offices)	(Zip Code)

(210) 249-4100
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). oYes oNo

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes x No

As of August 7, 2009, 111,513,842 shares of the issuer’s common stock, $0.001 par value, were outstanding.

PAYMENT DATA SYSTEMS, INC.

INDEX

PART I – FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS.

PAYMENT DATA SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS

	June 30, 2009 (Unaudited)	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 337,629	$ 103,428
Accounts receivable, net	144,775	158,736
Prepaid expenses and other	18,165	20,852
Total current assets	500,569	283,016
Property and equipment, net	42,742	62,114
Other assets:		
Related party receivable	210,000	246,168
Other assets	16,693	16,693
Total other assets	226,693	262,861
Total assets	$ 770,004	$ 607,991
Liabilities and stockholders' equity (deficit)		
Current liabilities:		
Accounts payable	$ 130,723	$ 108,055
Accrued expenses	1,262,487	751,379
Customer deposits payable	324,596	44,865
Deferred revenue	54,206	71,537
Total current liabilities	1,772,012	975,836
Stockholders' equity (deficit):		
Common stock, $0.001 par value, 200,000,000 shares authorized; 115,773,691 issued and 111,513,842 and 112,547,215 outstanding	115,774	115,774
Additional paid-in capital	55,444,770	55,444,770
Treasury stock, at cost; 4,259,849 and 3,226,476 shares	(212,420)	(176,252)
Deferred compensation	(2,153,800)	(2,328,184)
Accumulated deficit	(54,196,332)	(53,423,953)
Total stockholders' equity (deficit)	(1,002,008)	(367,845)
Total liabilities and stockholders' equity (deficit)	$ 770,004	$ 607,991

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Revenues	$ 834,993	$ 659,045	$ 1,653,809	$ 1,520,790
Operating expenses:				
Cost of services	679,076	571,181	1,373,661	1,253,374
Selling, general and administrative:				
Stock-based compensation	133,650	144,350	267,300	359,907
Other expenses	345,676	416,130	759,855	808,566
Depreciation	9,483	17,975	19,372	36,083
Total operating expenses	1,167,885	1,149,636	2,420,188	2,457,930
Operating loss	(332,892)	(490,591)	(766,379)	(937,140)
Other income (expense):				
Interest income	-	513	-	8,662
Interest expense	-	-	-	(193)
Other income (expense)	-	(1,160)	-	748,840
Total other income (expense), net	-	(647)	-	757,309
Loss before income taxes	(332,892)	(491,238)	(766,379)	(179,831)
Income taxes	3,000	-	6,000	-
Net loss	$ (335,892)	$ (491,238)	$ (772,379)	$ (179,831)
Basic and diluted net loss per common share:	$ 0.00	$ 0.00	$ (0.01)	$ 0.00
Weighted average common shares outstanding	111,513,842	99,991,359	112,016,255	89,162,132

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Operating activities:		
Net loss	$ (772,379)	$ (179,831)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	19,372	36,083
Non-cash issuance of common stock	-	78,255
Deferred compensation	174,384	229,134
Gain on sale of patents	-	(750,000)
Loss on disposition of assets		1,160
Changes in current assets and current liabilities:		
Accounts receivable	13,961	(49,336)
Prepaid expenses and other	2,687	4,965
Accounts payable and accrued expenses	533,776	36,209
Customer deposits payable	279,731	(13,107)
Deferred revenue	(17,331)	56,818
Net cash provided by (used in) operating activities	234,201	(549,650)
Investing activities:		
Proceeds from sale of patents	-	750,000
Purchases of property and equipment	-	(10,316)
Net cash provided by investing activities	-	739,684
Financing activities:		
Issuance of common stock, net of issuance costs	-	1,637
Net cash provided by financing activities	-	1,637
Change in cash and cash equivalents	234,201	191,671
Cash and cash equivalents, beginning of period	103,428	115,597
Cash and cash equivalents, end of period	$ 337,629	$ 307,268

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Note 1. Basis of Presentation

Payment Data Systems, Inc. and subsidiaries (the "Company"), has incurred substantial losses since inception, which has led to a deficit in working capital. The Company believes that its current available cash along with anticipated revenues may be insufficient to meet its anticipated cash needs for the foreseeable future. Consequently, the Company's ability to continue as a going concern is likely contingent on the Company receiving additional funds in the form of equity or debt financing. The Company is currently aggressively pursuing strategic alternatives. The sale of additional equity or convertible debt securities would result in additional dilution to the Company's stockholders, and debt financing, if available, may involve covenants which could restrict operations or finances. There can be no assurance that financing will be available in amounts or on terms acceptable to the Company, if at all. If the Company cannot raise funds on acceptable terms, or achieve positive cash flow, it may not be able to continue to exist, conduct operations, grow market share, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, any of which would negatively impact its business, operating results and financial condition. The accompanying unaudited consolidated financial statements of the Company do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

The accompanying unaudited consolidated financial statements of the Company have been prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal recurring nature considered necessary to present fairly the Company's financial position, results of operations and cash flows for such periods. The accompanying interim consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008. Results of operations for interim periods are not necessarily indicative of results that may be expected for any other interim periods or the full fiscal year.

Certain prior period amounts have been reclassified for comparative purposes to conform to the current period's presentation.

The preparation of financial statements in conformity with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2. Accrued Expenses

Accrued expenses consist of the following balances:

	June 30, 2009	December 31, 2008
Accrued salaries	$ 781,403	$ 311,880
Reserve for merchant losses	205,400	209,220

Accrued commissions		223,318		144,202
Accrued taxes		47,426		77,469
Other accrued expenses		4,940		8,608
Total accrued expenses	$	1,262,487	$	751,379

4

Note 3. Equity Line of Credit

On June 11, 2007, the Company entered into an agreement for an equity line of credit with Dutchess Private Equities Fund, LP ("Dutchess"). Under the terms of the agreement, the Company may elect to receive as much as $10 million from common stock purchases by Dutchess through August 23, 2012. During the six months ended June 30, 2009, the Company did not sell any common stock pursuant to the equity line of credit.

Note 4. Net Income (Loss) Per Share

Basic and diluted income (loss) per common share was calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Dilutive securities, which consist of stock options and warrants and convertible debt, were excluded from the computation of the weighted average number of common shares outstanding for purposes of calculating diluted income (loss) per common share because their effect was anti-dilutive.

Note 5. Related Party Transactions

As previously disclosed, in 2002 the Company recognized a loss on margin loans guaranteed by it for Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer; and Louis A. Hoch, then President and Chief Operating Officer, in the amount of $535,302 and $449,371, respectively. In February 2007, the Company signed employment agreements with Mr. Long and Mr. Hoch that require each to repay his respective obligation to the Company in four equal annual payments of cash or stock or any combination thereof. In December 2007, the Company accepted common stock and stock options valued at $133,826 and $112,343 from Mr. Long and Mr. Hoch, respectively, in satisfaction of their annual payments for 2007 as provided for under their employment agreements.

In December 2008, Mr. Long and Mr. Hoch did not pay the Company the second annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because the Company had deferred payment of their salary increases for 2008 called for under their respective employment agreements. At December 31, 2008, the Company owed Mr. Long and Mr. Hoch deferred salary of $110,000 and $100,000, respectively, and Mr. Long and Mr. Hoch owed the Company $133,825 and $112,343, respectively, for the second installment due by December 31, 2008. On March 30, 2009, the Company accepted 680,715 shares of the Company's common stock valued at $23,825 and 352,658 shares of the Company's common stock valued at $12,343 from Mr. Long and Mr. Hoch, respectively, in partial satisfaction of their annual payment due to the Company for 2008 as provided for under their employment agreements. The common stock accepted from Mr. Long and Mr. Hoch was valued at $0.035 per share, which was the closing price of the common stock on March 30, 2009. The common stock accepted from Mr. Long and Mr. Hoch was recorded as treasury stock with a total cost of $36,168. The total amount owed to the Company for the second installment is classified as Related Party Receivable on the Company's balance sheet and was $210,000 at June 30, 2009 and $246,168 at December 31, 2008.

During the six months ended June 30, 2009, the Company engaged Herb Authier to provide consulting services as an independent contractor related to network engineering and administration. The amount paid to Mr. Authier for such services was $15,000. Mr. Authier is the father-in-law of Louis Hoch, the Company's President and Chief Operating Officer.

Note 6. Legal Proceeding

On August 29, 2008, Tara Patrick p/k/a Carmen Electra, commenced legal action against the Company in the Superior Court of the State of California for the County of Los Angeles. On October 7, 2008, the Company removed that case to the United States District Court for the Central District of California – Los Angeles Division. With respect to the suit, the plaintiff alleges that the Company violated her rights of publicity and breached the terms of its license agreement with her. The plaintiff alleges and seeks resulting economic, exemplary and punitive damages, interest, attorneys' fees and costs of court. The Company believes this suit is without merit and intends to vigorously defend itself. In addition, on November 14, 2008, the Company filed a counterclaim against Ms. Patrick in the United States District Court for the Central District of California – Los Angeles Division alleging that she breached the terms of the Company's license agreement with her. The Company alleges and seeks to recover damages arising from Ms. Patrick's breach of the agreement. As of the date of this report, there have been no material developments in the suit. The results of legal proceedings cannot be predicted with certainty. If the Company fails to prevail in this legal matter, the Company's financial position, results of operations, and cash flows could be materially adversely affected.

On November 12, 2008, the Company commenced legal action against its former customers Commerce Planet, Inc. and Consumer Loyalty Group, Inc., in the 285th Judicial District Court of Bexar County, Texas. The Company alleged that they breached the terms of its services agreement with them and sought to recover economic damages and attorneys' fees. On January 22, 2009, the Court entered a Default Judgment awarding the Company actual damages in the amount of $140,472 and attorney's fees in the amount of $4,000. The Company was also awarded all costs of Court and pre-judgment and post-judgment interest as provided by law. The Company intends to pursue any legal means available to it in order to collect this judgment. As of the date of this report, no amounts have been collected towards this judgment.

Note 7. Subsequent Event

On July 21, 2009, the Company's Board of Directors granted a total of 100,000 shares of unrestricted common stock valued at $1,600 to an employee under the terms of the Company's Employee Comprehensive Stock Plan.

The Company evaluated subsequent events through the date of this report.

Item 2.MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

FORWARD-LOOKING STATEMENTS DISCLAIMER

This report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including the risks described in our annual report on Form 10-K and other reports we file with the Securities and Exchange Commission. Although we believe the expectations reflected in the forward-looking statements are reasonable, they relate only to events as of the date on which the statements are made. We do not intend to update any of the forward-looking statements after the date of this report to conform these statements to actual results or to changes in our expectations, except as required by law.

This discussion and analysis should be read in conjunction with the unaudited interim consolidated financial statements and the notes thereto included in this report, and our annual report on Form 10-K for the fiscal year ended December 31, 2008.

Overview

We provide integrated electronic payment processing services to merchants and businesses, including credit and debit card-based processing services and transaction processing via the Automated Clearinghouse Network. We also operate an online payment processing service for consumers under the domain name www.billx.com through which consumers can pay anyone. Since inception, we have incurred operating losses each quarter, and as of June 30, 2009, we have an accumulated deficit of approximately $54.2 million. Our prospects to continue as a going concern must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of growth, particularly companies in rapidly evolving markets such as electronic commerce. To address these risks we must, among other things, grow and maintain our customer base, implement a successful marketing strategy, continue to maintain and upgrade our technology and transaction-processing systems, provide superior customer service, respond to competitive developments, attract, retain and motivate qualified personnel, and respond to unforeseen industry developments and other factors. We cannot assure you that we will be successful in addressing such risks, and the failure to do so could have a material adverse effect on our business, prospects, financial condition and results of operations. We believe that our success will depend in large part on our ability to (a) manage our operating expenses, (b) add quality customers to our client base, (c) meet evolving customer requirements and (d) adapt to technological changes in an emerging market. Accordingly, we intend to focus on customer acquisition activities and outsource some of our processing services to third parties to allow us to maintain an efficient operating infrastructure and expand our operations without significantly increasing our fixed operating expenses.

Critical Accounting Policies

General

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to the reported amounts of revenues and expenses, bad debt, investments, intangible assets, income taxes, and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates under different assumptions or conditions. We consider the following accounting policies to be critical because the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change or because the impact of the estimates and assumptions on financial condition or operating performance is material.

Revenue Recognition

Revenue consists primarily of fees generated through the electronic processing of payment transactions and related services, and are recognized as revenue in the period the transactions are processed or when the related services are performed. Merchants may be charged for these processing services at a bundled rate based on a percentage of the dollar amount of each transaction and, in some instances, additional fees are charged for each transaction. Certain merchant customers are charged a flat fee per transaction, while others may also be charged miscellaneous fees, including fees for chargebacks or returns, monthly minimums, and other miscellaneous services. Revenues derived from electronic processing of credit and debit card transactions that are authorized and captured through third-party networks are reported gross of amounts paid to sponsor banks as well as interchange and assessments paid to credit card associations (MasterCard and Visa). Revenue also includes any up-front fees for the work involved in implementing the basic functionality required to provide electronic payment processing services to a customer. Revenue from such implementation fees is recognized over the term of the related service contract. Sales taxes billed are reported directly as a liability to the taxing authority, and are not included in revenue.

Reserve for Losses on Card Processing

If, due to insolvency or bankruptcy of the merchant, or for another reason, we are not able to collect amounts from our card processing merchant customers that have been properly "charged back" by the cardholders, we must bear the credit risk for the full amount of the cardholder transaction. We may require cash deposits and other types of collateral from certain merchants to minimize any such risk. In addition, we utilize a number of systems and procedures to manage merchant risk. Card merchant processing loss reserves are primarily determined by performing a historical analysis of our chargeback loss experience and considering other factors that could affect that experience in the future, such as the types of card transactions processed and nature of the merchant relationship with their consumers. This reserve amount is subject to risk that actual losses may be greater than our estimates. At June 30, 2009, our card merchant processing loss reserve was $205,400. We have not incurred any significant chargeback losses to date. Our estimate for chargeback losses is likely to increase in the future as our volume of card-based transactions processed increases.

Bad Debts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability or failure of our customers to make required payments. We determine the allowance for doubtful accounts based on an account-by-account review, taking into consideration such factors as the age of the outstanding balance, historical pattern of collections and financial condition of the customer. Past losses incurred by us due to bad debts have been within our expectations. In 2008, we did not charge any bad debt expense and recorded bad debt write-offs of $1,749 against our allowance for doubtful accounts. At June 30, 2009, the balance of the allowance for doubtful accounts was approximately $30,000. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make contractual payments, additional allowances may be required. Our estimate for bad debt losses is likely to increase in the future as our volume of transactions processed increases.

Valuation of Long-Lived and Intangible Assets

We assess the impairment of long-lived and intangible assets at least annually, and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important, which could trigger an impairment review, include the following: significant underperformance relative to historical or projected future cash flows; significant changes in the manner of use of the assets or the strategy of the overall business; and significant negative industry trends. When management determines that the carrying value of long-lived and intangible assets may not be recoverable, impairment is measured as the excess of the assets' carrying value over the estimated fair value. No impairment losses were recorded in 2008 or during the six months ended June 30, 2009.

Income Taxes

Deferred tax assets and liabilities are recorded based on the difference between the tax bases of assets and liabilities and their carrying amount for financial reporting purposes, as measured by the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Deferred tax assets are computed with the presumption that they will be realizable in future periods when pre-taxable income is generated. Predicting the ability to realize these assets in future periods requires a great deal of judgment by management. It is our judgment that we cannot predict with reasonable certainty that the deferred tax assets as of June 30, 2009 will be realized in future periods. Accordingly, a valuation allowance has been provided to reduce the net deferred tax assets to $0. At December 31, 2008, we had available net operating loss carryforwards of approximately $41.1 million, which expire beginning in the year 2020.

We follow FASB Interpretation No. 48 (“FIN 48”), “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109,” which requires that only income tax benefits that meet the “more likely than not” recognition threshold be recognized. We do not have any unrecognized income tax benefits at June 30, 2009 or December 31, 2008.

Effect of New Accounting Pronouncements

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (“SFAS 161”). SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” currently establishes the disclosure requirements for derivative instruments and hedging activities. SFAS 161 amends and expands the disclosure requirements of SFAS No. 133 with enhanced quantitative, qualitative and credit risk disclosures. The adoption of SFAS 161 effective January 1, 2009 did not have a material impact on our consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, “Subsequent Events” (“SFAS 165”), which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This statement sets forth the circumstances under which en entity should recognize events or transactions occurring after the balance sheet date in its financial statements. SFAS 165 also requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date – that is, whether that date represents the date the financial statements were issued or were available to be issued. This statement is effective for interim or annual reporting periods ending after June 15, 2009. During the quarter ended June 30, 2009, the Company adopted SFAS 165. The Company evaluated subsequent events through the date and time the financial statements were issued. The adoption of SFAS 165 did not have a material impact on the Company’s consolidated financial statements.

In June 2009, the FASB issued SFAS No. 168, “The FASB Accounting Standards Codification (the “Codification”) and the Hierarchy of Generally Accepted Accounting Principles” (“SFAS 168”). SFAS 168 confirmed that the Codification will become the single official source of authoritative U.S. Generally Accepted Accounting Principles (“GAAP”), (other than guidance issued by the SEC), superseding existing FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force (“EITF”), and related literature. After that date, only one level of authoritative U.S. GAAP will exist. All other literature will be considered non-authoritative. The Codification does not change U.S. GAAP; instead, it introduces a new structure that is organized in an easily accessible, user-friendly online research system. The Codification, which changes the referencing of financial standards, becomes effective for interim and annual periods ending on or after September 15, 2009. The Company will apply the Codification beginning in the third quarter of fiscal 2009. The adoption of SFAS 168 is not expected to have a material impact on the Company’s consolidated financial statements.

Results of Operations

Our revenues are principally derived from providing integrated electronic payment services to merchants and businesses, including credit and debit card-based processing services and transaction processing via the Automated Clearinghouse Network. We also operate an online payment processing service for consumers under the domain name www.billx.com and sell this service as a private-label application to resellers. Revenues for the quarter ended June 30, 2009 increased 27% to $834,993 from $659,045 for the quarter ended June 30, 2008. Revenues for the six months ended June 30, 2009 increased 9% to $1,653,809 from $1,520,790 for the six months ended June 30, 2008. The increase from the prior year periods was primarily attributable to the increase in revenues generated from card-based processing services due to increased transaction volume. The monthly average number of consumers using our billx.com online payment service decreased to 532 in the first six months of 2009 from 778 in the first six months of 2008. We expect this trend to continue unless our current plan to introduce and establish enhanced value by offering a prepaid MasterCard in conjunction with our online payment service is successful in generating subscriber growth.

Cost of services includes the cost of personnel dedicated to the creation and maintenance of connections to third-party payment processors and fees paid to such third-party providers for electronic payment processing services. Through our contractual relationships with our payment processors, we are able to process Automated Clearinghouse and debit or credit card transactions on behalf of our customers and their consumers. We pay volume-based fees for debit and credit transactions initiated through these processors, and pay fees for other transactions such as returns, notices of change to bank accounts and file transmission. Cost of services was $679,076 and $571,181 for the quarters ended June 30, 2009 and 2008, respectively and $1,373,661 and $1,253,374 for the six months ended June 30, 2009 and 2008, respectively. The increase from the prior year periods was due primarily to the increase in fees related to processing the increased card-based transaction volume.

Stock-based compensation expenses decreased to $133,650 for the quarter ended June 30, 2009, from $144,350 for the second quarter of 2008. Stock-based compensation expenses decreased to $267,300 for the six months ended June 30, 2008, from $359,907 for the same period of 2008. The change from the prior year quarter was principally due to approximately $9,000 of expense in the prior year quarter related to stock grants made to advisory board members that were fully amortized at December 31, 2008. The change from the prior year six month period was principally due to approximately $49,000 of expense in the prior year period related to incentive stock grants made to employees in March 2005 that were fully amortized at March 31, 2008.

Other selling, general and administrative expenses decreased to $345,676 for the quarter ended June 30, 2009, from $416,130 for the second quarter of 2008. Other selling, general and administrative expenses for the six months ended June 30, 2009 decreased to $759,855 from $808,566 for the six months ended June 30, 2008. The decreases from the prior year periods were principally due to lower professional consulting fees.

Depreciation and amortization was $9,483 and $17,975 for the quarter ended June 30, 2009 and 2008, respectively. Depreciation for the six months ended June 30, 2009 decreased to $19,372 from $36,083 for the six months ended June 30, 2008. The decreases from the prior periods were primarily due to lower depreciation expense related to certain assets that became fully depreciated during 2008. We did not make any capital expenditures during the six months ended June 30, 2009.

There was no net other expense for the second quarter of 2009 as compared to net other expense of $647 for the quarter ended June 30, 2008. There was no net other income for the first six months of 2009 as compared to net other income of $757,309 for the six months ended June 30, 2008. The decrease from the prior year period was primarily attributable to a $750,000 gain on the sale of certain patents in January 2008.

Net loss decreased to $335,892 for the quarter ended June 30, 2009 from $491,238 for the second quarter of 2008 and increased to $772,379 for the six months ended June 30, 2009 from $179,831 for the prior year comparable period, as a result of the items discussed above.

Liquidity and Capital Resources

At June 30, 2009, we had $337,629 of cash and cash equivalents, compared to $103,428 of cash and cash equivalents at December 31, 2008. We have incurred substantial losses since inception and have a deficit in net working capital. We believe that our current available cash and cash equivalents along with anticipated revenues may be insufficient to meet our anticipated cash needs for the foreseeable future. Consequently, our ability to continue as a going concern may be contingent on us receiving additional funds in the form of equity or debt financing. We are currently aggressively pursuing strategic financing alternatives.

On June 11, 2007, we entered into an agreement for an equity line of credit with Dutchess Private Equities Fund, LP. Under the terms of the agreement, we may elect to receive as much as $10 million from common stock purchases by Dutchess through August 23, 2012. Through June 30, 2009, we sold 1,535,263 shares of our common stock pursuant to the new equity line of credit and received total proceeds, net of issuance costs, of $75,064.

The satisfactory completion of additional sales of common stock to private investors or under our equity line of credit, borrowing funds, or growth of cash flow from operations is essential to provide sufficient cash flows to meet our current operating requirements. The sale of additional equity or convertible debt securities would result in additional dilution to our stockholders, and debt financing, if available, may involve restrictive covenants which could restrict our operations or finances. Financing may not be available in amounts or on terms acceptable to us, if at all. If we cannot raise funds on acceptable terms or achieve positive cash flow, we may not be able to continue to exist, conduct operations, grow market share, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, any of which would negatively impact our business, operating results and financial condition.

Net cash provided by operating activities was $234,201 for the six months ended June 30, 2009 and cash used in operating activities was $549,650 for the six months ended June 30, 2008. Net cash provided by operating activities in 2009 was primarily attributable to the increase in customer deposit payables, which consist of cash held in transit that we collected on behalf of our merchants via the ACH system. Net cash used in operating activities in 2008 was primarily attributable to operating losses generated by growth stage activities and overhead costs. We plan to focus on expending our resources prudently given our current state of liquidity.

There were no cash flows generated by investing activities for the six months ended June 30, 2009. Net cash provided by investing activities of $739,684 for the six months ended June 30, 2008 resulted from receiving $750,000 in proceeds from the sale of our patents and making capital expenditures for computer hardware and software of $10,316.

There were no cash flows generated by financing activities for the six months ended June 30, 2009. Net cash provided by financing activities of $1,637 for the six months ended June 30, 2008 represented the net proceeds from the issuance of common stock under our equity line of credit.

Off-balance Sheet Arrangements

We currently have no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in Item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this Item.

Item 4T. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer / Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this quarterly report on Form 10-Q. Based on that evaluation, our Chief Executive Officer / Chief Financial Officer concluded that our disclosure controls and procedures as of June 30, 2009 are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer / Chief Financial Officer, as appropriate, to allow timely decisions regarding required reasonable assurance that such information is accumulated and communicated to our management. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management. Our disclosure controls and procedures include components of our internal control over financial reporting. Management's assessment of the effectiveness of our internal control over financial reporting is expressed at the level of reasonable assurance that the control system, no matter how well designed and operated, can provide only reasonable, but not absolute, assurance that the control system's objectives will be met.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the quarter ended June 30, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

As previously disclosed, in 2002 the Company recognized a loss on margin loans guaranteed by it for Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer; and Louis A. Hoch, then President and Chief Operating Officer, in the amount of $535,302 and $449,371, respectively. In February 2007, we signed employment agreements with Mr. Long and Mr. Hoch that require each to repay his respective obligation to us in four equal annual payments of cash or stock or any combination thereof. In December 2007, we accepted common stock and stock options valued at $133,826 and $112,343 from Mr. Long and Mr. Hoch, respectively, in satisfaction of their annual payments for 2007 as provided for under their employment agreements.

In December 2008, Mr. Long and Mr. Hoch did not pay us the second annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because we had deferred payment of their salary increases for 2008 called for under their respective employment agreements. At December 31, 2008, we owed Mr. Long and Mr. Hoch deferred salary of $110,000 and $100,000, respectively, and Mr. Long and Mr. Hoch owed us $133,825 and $112,343, respectively, for the second installment due by December 31, 2008. On March 30, 2009, we accepted 680,715 shares of our common stock valued at $23,825 and 352,658 shares of our common stock valued at $12,343 from Mr. Long and Mr. Hoch, respectively, in partial satisfaction of their annual payment due to us for 2008 as provided for under their employment agreements. The common stock accepted from Mr. Long and Mr. Hoch was valued at $0.035 per share, which was the closing price of our common stock on March 30, 2009. The common stock accepted from Mr. Long and Mr. Hoch was recorded as treasury stock with a total cost of $36,168. The total amount owed to us for the second installment is classified as Related Party Receivable on our balance sheet and was $210,000 at June 30, 2009 and $246,168 at December 31, 2008.

On August 29, 2008, Tara Patrick p/k/a Carmen Electra, commenced legal action against us in the Superior Court of the State of California for the County of Los Angeles. On October 7, 2008, we removed that case to the United States District Court for the Central District of California – Los Angeles Division. With respect to the suit, the plaintiff alleges that we violated her rights of publicity and breached the terms of our license agreement with her. The plaintiff alleges and seeks resulting economic, exemplary and punitive damages, interest, attorneys' fees and costs of court. We believe this suit is without merit and intend to vigorously defend ourselves. In addition, on November 14, 2008, we filed a counterclaim against Ms. Patrick in the United States District Court for the Central District of California – Los Angeles Division alleging that she breached the terms of our license agreement with her. We allege and seek to recover damages arising from Ms. Patrick's breach of the agreement. As of the date of this report, there have been no material developments in the suit. The results of legal proceedings cannot be predicted with certainty. If we fail to prevail in this legal matter, our financial position, results of operations, and cash flows could be materially adversely affected.

On November 12, 2008, we commenced legal action against our former customers Commerce Planet, Inc. and Consumer Loyalty Group, Inc., in the 285th Judicial District Court of Bexar County, Texas. We alleged that they breached the terms of our services agreement with them and sought to recover economic damages and attorneys' fees. On January 22, 2009, the Court entered a Default Judgment awarding us actual damages in the amount of $140,472 and attorney's fees in the amount of $4,000. We were also awarded all costs of Court and pre-judgment and post-judgment interest as provided by law. We intend to pursue any legal means available to us in order to collect this judgment. As of the date of this report, we have not collected any amounts towards this judgment.

Item 1A. RISK FACTORS.

There have been no material changes from risk factors previously disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2008.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

During the quarter ended June 30, 2009, we did not sell any unregistered securities.

Item 3. DEFAULTS UPON SENIOR SECURITIES.

During the quarter ended June 30, 2009, we did not default on any senior securities.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

There were no matters submitted to a vote of our stockholders during the second quarter of fiscal year 2009.

Item 5. OTHER INFORMATION.

Not applicable.

Item 6. EXHIBITS.

Exhibit Number	Description
3.1	Amended and Restated Articles of Incorporation (included as exhibit 3.1 to the Form 10-KSB filed March 31, 2006, and incorporated herein by reference).
3.2	Amended and Restated By-laws (included as exhibit 3.2 to the Form 10-KSB filed March 31, 2006, and incorporated herein by reference).
4.1	Amended and Restated 1999 Employee Comprehensive Stock Plan (included as exhibit 10.1 to the Form 8-K filed January 3, 2006, and incorporated herein by reference).
4.2	Amended and Restated 1999 Non-Employee Director Plan (included as exhibit 10.2 to the Form 8-K filed January 3, 2006, and incorporated herein by reference).
4.3	Employee Stock Purchase Plan (included as exhibit 4.3 to the Form S-8 filed February 23, 2000, and incorporated herein by reference).
4.4	Amended Registration Rights Agreement between the Company and Dutchess Private Equities Fund, Ltd., dated August 21, 2007 (included as exhibit 10.2 to the Form 8-K filed August 23, 2007, and incorporated herein by reference).
4.5	Rights Agreement between the Company and American Stock Transfer & Trust Company, dated February 28, 2007 (included as exhibit 4.1 to the Form 8-K filed March 5, 2007, and incorporated herein by reference).

10.1	Lease Agreement between the Company and Frost National Bank, Trustee for a Designated Trust, dated August 2003 (included as exhibit 10.3 to the Form 10-Q filed November 14, 2003, and incorporated herein by reference).
10.2	Employment Agreement between the Company and Michael R. Long, dated February 27, 2007 (included as exhibit 10.1 to the Form 8-K filed March 2, 2007, and incorporated herein by reference).

10.3	Employment Agreement between the Company and Louis A. Hoch, dated February 27, 2007 (included as exhibit 10.2 to the Form 8-K filed March 2, 2007, and incorporated herein by reference).
10.4	Investment Agreement between the Company and Dutchess Private Equities Fund, LP, dated June 4, 2004 (included as exhibit 10.8 to the Form SB-2 filed June 18, 2004, and incorporated herein by reference).
10.5	Placement Agent Agreement between the Company, Charleston Capital Corporation, and Dutchess Private Equities Fund, LP, dated June 4, 2004 (included as exhibit 10.10 to the Form SB-2 filed June 18, 2004, and incorporated herein by reference).
10.6	Affiliate Office Agreement between the Company and Network 1 Financial, Inc. (included as exhibit 10.11 to the Form SB-2 filed April 28, 2004, and incorporated herein by reference).
10.7	Warrant Agreement between the Company and Kubra Data Transfer LTD, dated as of September 30, 2004 (included as exhibit 10.1 to the Form 8-K filed October 6, 2004, and incorporated herein by reference).
10.8	Promissory Note between the Company and Dutchess Private Equities Fund, II, LP, dated August 21, 2006 (included as exhibit 10.1 to the Form 8-K filed August 25, 2006, and incorporated herein by reference).
10.9	Stock Purchase Agreement between the Company and Robert D. Evans, dated January 18, 2007 (included as exhibit 10.1 to the Form 8-K filed January 23, 2007, and incorporated herein by reference).
10.10	Stock Purchase Agreement between the Company and Robert D. Evans, dated March 1, 2007 (included as exhibit 10.1 to the Form 8-K filed March 5, 2007, and incorporated herein by reference).
10.11	Amended Investment Agreement between the Company and Dutchess Private Equities Fund, Ltd., dated August 21, 2007 (included as exhibit 10.16 to the Form 8-K filed August 23, 2007, and incorporated herein by reference).
10.12	Amended Registration Rights Agreement between the Company and Dutchess Private Equities Fund, Ltd., dated August 21, 2007 (included as exhibit 10.2 to the Form 8-K filed August 23, 2007, and incorporated herein by reference).
10.13	Trademark and Domain Name Purchase Agreement between the Company and Alivio Holdings, LLC, dated November 14, 2005 (included as exhibit 10.1 to the Form 8-K filed November 17, 2005, and incorporated herein by reference).
10.14	Patent Purchase Agreement between the Company and PCT Software Data, LLC, dated January 11, 2008 (included as exhibit 10.14 to the Form 10-K filed March 27, 2008, and incorporated herein by reference).
31.1	Certification of the Chief Executive Officer/Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification of the Chief Executive Officer/Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PAYMENT DATA SYSTEMS, INC.

Date: August 14, 2009	By:	/s/ Michael R. Long Michael R. Long Chairman of the Board, Chief Executive Officer and Chief Financial Officer

(principal executive officer and principal financial and accounting officer)