PAYMENT DATA SYSTEMS INC
Form 10-Q
November 15, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010.

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

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	o	Accelerated filer	o
Non-accelerated filer (Do not check if a smaller reporting company)	o	Smaller reporting company	þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). þYes o No

As of November 1, 2010, 125,278,547 shares of the issuer's common stock, $0.001 par value, were outstanding.

PAYMENT DATA SYSTEMS, INC.

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PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

PAYMENT DATA SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS

	September 30, 2010 (Unaudited)	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 129,262	$ 565,597
Accounts receivable, net	111,683	92,545
Prepaid expenses and other	23,014	16,269
Total current assets	263,959	674,411
Property and equipment, net	7,281	25,597
Other assets:		
Marketable securities	94,810	-
Related party receivable	456,168	456,168
Other assets	31,693	6,693
Total other assets	582,671	462,861
Total assets	$ 853,911	$ 1,162,869
Liabilities and stockholders' equity (deficit)		
Current liabilities:		
Accounts payable	$ 68,045	$ 99,738
Accrued expenses	1,169,551	1,480,929
Customer deposits payable	122,579	449,372
Deferred revenue	20,410	17,336
Total current liabilities	1,380,585	2,047,375
Stockholders' equity (deficit):		
Common stock, $0.001 par value, 200,000,000 shares authorized; 130,273,691 and 115,173,691 issued and 125,278,547 and 110,778,547 outstanding	130,274	115,774
Additional paid-in capital	55,863,870	55,444,770
Treasury stock, at cost; 4,995,144 shares	(238,155)	(238,155)
Deferred compensation	(1,717,840)	(1,979,416)
Accumulated deficit	(54,564,823)	(54,227,479)
Total stockholders' equity (deficit)	(526,674)	(884,506)
Total liabilities and stockholders' equity (deficit)	$ 853,911	$ 1,162,869

See notes to interim consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenues	$648,927	$841,278	$1,855,599	$2,495,087
Operating expenses:				
Cost of services	496,249	476,651	1,442,038	1,850,312
Selling, general and administrative:				
Stock-based compensation	133,650	133,650	400,950	400,950
Other expenses	148,969	196,721	475,604	956,576
Depreciation	4,685	8,691	18,316	28,063
Total operating expenses	783,553	815,713	2,336,908	3,235,901
Operating loss	(134,626)	25,565	(481,309)	(740,814)
Other income (expense):				
Interest income	-	-	-	-
Interest expense	-	-	-	-
Other income (expense)	(4,990)	-	155,010	-
Total other income (expense), net	(4,990)	-	155,010	-
Loss before income taxes	(139,616)	25,565	(326,299)	(740,814)
Income taxes	2,500	3,000	11,045	9,000
Net loss	$(142,116)	$22,565	$(337,344)	$(749,814)
Basic and diluted net loss per common share:	$0.00	$0.00	$0.00	$(0.01)
Weighted average common shares outstanding	125,308,808	111,385,965	119,803,030	111,846,944

See notes to interim consolidated financial statements.

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

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Operating activities:		
Net loss	$(337,344)	$(749,814)
Adjustments to reconcile net loss to net cash provided (used) by operating activities:		
Marketable securities received in litigation settlement	(100,000)	-
Unrealized loss on change in fair value of marketable securities	4,990	-
Depreciation	18,316	28,063
Deferred compensation	261,576	261,576
Bad debt	-	2,435
Changes in current assets and current liabilities:		
Accounts receivable	(19,138)	12,761
Prepaid expenses and other	(6,745)	14,554
Accounts payable and accrued expenses	90,529	432,721
Customer deposits payable	(326,793)	295,921
Deferred revenue	3,074	(52,297)
Net cash provided (used) by operating activities	(411,535)	245,920
Investing activities:		
Proceeds from sale of marketable securities	200	-
Other assets	(25,000)	-
Net cash used by investing activities	(24,800)	-
Change in cash and cash equivalents	(436,335)	245,920
Cash and cash equivalents, beginning of period	565,597	103,428
Cash and cash equivalents, end of period	$129,262	$349,348

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 continuing deficit in working capital. The Company believes 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. Accordingly, the Company is pursuing strategic financing alternatives in addition to its equity line of credit (see Note 3). The sale of 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, 2009. 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.

Marketable Securities: The Company classifies its marketable security investment portfolio as either held to maturity, available-for-sale, or trading. At September 30, 2010, all of the Company’s marketable securities were trading. Securities classified as trading are carried at fair value with unrealized gains and losses included in the consolidated statement of operations. Classification as current or non-current is based primarily on whether there is an active public market for such security.

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:

	September 30, 2010	December 31, 2009
Accrued salaries	$ 854,018	$ 1,195,683
Reserve for merchant losses	205,400	205,400
Accrued commissions	48,490	39,362
Accrued taxes	35,418	36,724
Other accrued expenses	26,225	3,760
Total accrued expenses	$ 1,169,551	$ 1,480,929

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 over a five year period. The Company filed a registration statement on Form SB-2 to register the resale of these shares with the SEC, which declared the registration statement effective on September 10, 2007. Due to this registration statement becoming stale, the Company did not sell any common stock pursuant to the equity line of credit during 2010.

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, 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. Fair Value Measurements

ASC Topic 820 established a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements).

The three levels of the fair value hierarchy defined by the standard are as follows:

Level 1: Quoted prices are available in active markets for identical assets or liabilities;

Level 2: Quoted prices in active markets for similar assets and liabilities that are observable for the asset or liability; or

Level 3: Unobservable pricing inputs that are generally less observable from objective sources, such as discounted cash flow models or valuations.

The following table sets forth by level within the fair value hierarchy the Company’s financial assets and liabilities that are accounted for at fair value. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company’s assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

	September 30, 2010			
Recurring Fair Value Measures	Level 1	Level 2	Level 3	Total
Assets:				
Marketable securities	$ 94,810	$ -	$ -	$ 94,810
Liabilities:				
None	$ -	$ -	$ -	$ -

	December 31, 2009			
Recurring Fair Value Measures	Level 1	Level 2	Level 3	Total
Assets:				
Marketable securities	$ -	$ -	$ -	$ -
Liabilities:				
None	$ -	$ -	$ -	$ -

The Company's financial instruments relate to its trading marketable securities, which are valued using quoted market prices. Adjustments to fair value are recorded in the consolidated statement of operations.

Note 6. Related Party Transactions

As previously disclosed, in 2002 the Company recognized a loss on margin loans it guaranteed 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. The total amount owed to the Company for the second installment was $246,168. 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 partial payments of $23,825 and $12,343 made to the Company by Mr. Long and Mr. Hoch, respectively, equaled the difference between the amount each owed to the Company for the second installment and the amount the Company owed to each for deferred salary. 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.

In December 2009, Mr. Long and Mr. Hoch did not pay the Company the third annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because the Company had partially deferred payment of their salary for 2009 called for under their respective employment agreements. At December 31, 2009, the Company owed Mr. Long and Mr. Hoch deferred salary for 2009 of $162,385 and $141,808, respectively, and Mr. Long and Mr. Hoch owed the Company $133,825 and $112,343, respectively, for the third installment due by December 31, 2009. The total amount owed to the Company for the unpaid installments is classified as Related Party Receivable on the Company’s balance sheet and was $456,168 at both September 30, 2010 and December 31, 2009.

On April 12, 2010, the Company executed amendments to its employment agreements with Michael Long, Chief Executive Officer and Chief Financial Officer, and Louis Hoch, President and Chief Operating Officer. Under the terms of their respective amended employment agreements, Mr. Long and Mr. Hoch agreed to reduce their annual base salaries for 2010 to $24,000 each from $375,000 and $350,000, respectively, and change the annual bonus limit from 100% of current salary to 100% of the highest salary received in any year of the agreement.

During the nine months ended September 30, 2010, the Company employed Herb Authier to provide services related to network engineering and administration. The amount paid to Mr. Authier for such services was $22,500. Mr. Authier is the father-in-law of Louis Hoch, the Company’s President and Chief Operating Officer.

Note 7. Legal Proceeding

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 their services agreement with it 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. On or about January 1, 2009, Commerce Planet entered into an Asset Purchase Agreement with Morlex, Inc. Pursuant to this agreement, Commerce Planet’s liabilities were assigned to and/or assumed by Morlex, including the debt owed to the Company. On May 27, 2009, the Company commenced legal action against Morlex, Inc., in the 285th Judicial District Court of Bexar County, Texas. On September 2, 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 $7,500. The Company was also awarded all costs of Court and pre-judgment and post-judgment interest as provided by law.

On March 2, 2010, the Company entered into a settlement agreement with Commerce Planet, Inc. Under the terms of the settlement, Commerce Planet agreed to pay the Company $75,000 and issue 5,000,000 shares of Commerce Planet common stock to the Company on or before April 2, 2010. Additionally, both parties released all claims against each other. On March 2, 2010, the Company received payment of $75,000 from Commerce Planet in accordance with the terms of the settlement.

On July 1, 2010, the Company was issued 5,000,000 shares of Commerce Planet common stock eligible for sale pursuant to Rule 144 under the terms of the settlement agreement with Commerce Planet, Inc. The common stock was valued at $100,000, or $0.02 per share, based on the closing price of the stock on June 30, 2010. During July 2010, the Company sold 10,000 shares of the Commerce Planet common stock on the open market for $200, or $0.02 per share. The 4,990,000 shares of Commerce Planet common stock is classified as non-current marketable securities on the Company’s balance sheet at September 30, 2010.

Note 8. Subsequent Events

On November 4, 2010, Michael Long, Chief Executive Officer and Chief Financial Officer, and Louis Hoch, President and Chief Operating Officer, were each granted 5,400,000 shares of restricted common stock by the Company as an annual bonus valued at $216,000 pursuant to the terms of their respective employment agreements. The number of shares granted to each officer was based on the closing price of the common stock on October 15, 2010, which was $0.04 per share.

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, 2009.

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 September 30, 2010, we have an accumulated deficit of approximately $54.6 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 September 30, 2010, 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 2009, we recorded $18,435 of bad debt expense and $6,734 of bad debt write-offs against our allowance for doubtful accounts. In the nine months ended September 30, 2010, we did not record any bad debt expense or bad debt write-offs. At September 30, 2010, the balance of the allowance for doubtful accounts was approximately $42,000. If the financial conditions 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 2009 or during the nine months ended September 30, 2010.

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 September 30, 2010 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, 2009, we had available net operating loss carryforwards of approximately $41.9 million, which expire beginning in the year 2020.

We follow ASC Topic 740-10, “Income Taxes.” ASC Topic 740-10 clarified the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. ASC Topic 740-10 provides guidance regarding the recognition, measurement, presentation and disclosure in the financial statements of tax positions taken or expected to be taken on a tax return. ASC Topic 740-10 requires that only income tax benefits that meet the “more likely than not” recognition threshold be recognized or continue to be recognized on its effective date. We have not recorded any unrecognized income tax benefits since the adoption of ASC Topic 740-10.

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 September 30, 2010 decreased 23% to $648,927 from $841,278 for the quarter ended September 30, 2009. Revenues for the nine months ended September 30, 2010 decreased 26% to $1,855,599 from $2,495,087 for the nine months ended September 30, 2009. The decrease from the prior year periods was primarily attributable to decreased transaction volume from card-based processing services due to the loss of our two largest customers. During October 2009, our largest customer, Access General Insurance, ceased using our processing services on an exclusive basis in what we alleged was a violation of its service agreements with us. We commenced legal action in November 2009 against Access General for the breach of its agreements with us and entered into a settlement agreement with Access General in December 2009. Consequently, Access General has not generated any significant revenues for us in 2010. Services provided to Access General accounted for approximately 35% of our total revenues for the third quarter of 2009 and 32% of our total revenues for the nine months ended September 30, 2009. Also, our second largest customer, Protection One, ceased using our processing services in January 2010 and has not generated any significant revenues for us in 2010. Services provided to Protection One accounted for approximately 14% of our total revenues for both the quarter and nine months ended September 30, 2009.

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 $496,249 for the quarter ended September 30, 2010 and $476,651 for the quarter ended September 30, 2009. Cost of services was $1,442,038 for the nine months ended September 30, 2010 and $1,850,312 for the nine months ended September 30, 2009. The increase from the prior year quarter was attributable to an adjustment in the third quarter of 2009 for accrued fees that will not be paid to a reseller due to its breach of our related service agreements. The decrease from the prior year period was due primarily to the decrease in costs related to processing the decreased card-based transaction volume.

Stock-based compensation expenses were $133,650 and $400,950 for the quarter and nine months ended September 30, 2010 and 2009, respectively, and represent the amortization of deferred compensation expense related to incentive stock grants to employees and the accrual of annual bonuses called for under executive employee agreements.

Other selling, general and administrative expenses decreased to $148,969 for the quarter ended September 30, 2010, from $196,721for the second quarter of 2009. Other selling, general and administrative expenses for the nine months ended September 30, 2010 decreased to $475,604 from $956,576 for the nine months ended September 30, 2009. The decrease from the prior year periods was principally due to lower salaries expense in 2010 pursuant to amended executive employment agreements and salary reductions for certain other employees. On April 12, 2010, Michael Long, Chief Executive Officer and Chief Financial Officer, and Louis Hoch, President and Chief Operating Officer, agreed to reduce their annual base salaries for 2010 to $24,000 each from $375,000 and $350,000, respectively.

Depreciation and amortization was $4,685 for the quarter ended September 30, 2010 and $8,691 for the quarter ended September 30, 2009. Depreciation for the nine months ended September 30, 2010 decreased to $18,316 from $28,063 for the nine months ended September 30, 2009. The decrease from the prior year periods was primarily due to lower depreciation expense related to certain assets that became fully depreciated during 2009. We did not capitalize any expenditures during the quarter ended September 30, 2010.

Net other expense of $4,990 for the quarter ended September 30, 2010 was attributable to the write-down of Commerce Planet common stock held for sale to market value at September 30, 2010. Net other income of $155,010 for the first nine months of 2010 was primarily attributable to a legal settlement with a former customer, Commerce Planet, in March 2010. There was no net other income for the first nine months of 2009.

We reported a net loss of $142,116 for the quarter ended September 30, 2010 compared to net income of $22,565 for the third quarter of 2009, and reported a net loss of $337,344 for the nine months ended September 30, 2010 compared to a net loss of $749,814 for the prior year comparable period, as a result of the items discussed above.

Liquidity and Capital Resources

At September 30, 2010, we had $129,262 of cash and cash equivalents, compared to $565,597 of cash and cash equivalents at December 31, 2009. 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 over a period of five years. The Company filed a registration statement on Form SB-2 to register the resale of these shares with the SEC, which declared the registration statement effective on September 10, 2007. Subsequent to the effective date through December 31, 2009, we sold 1,535,263 shares of our common stock pursuant to the equity line of credit and received total proceeds, net of issuance costs, of $75,064. Due to this registration statement becoming stale, the Company did not sell any common stock pursuant to the equity line of credit during 2010.

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 used by operating activities was $411,535 for the nine months ended September 30, 2010 and cash provided by operating activities was $245,920 for the nine months ended September 30, 2009. Net cash used in operating activities in the first nine months of 2010 was primarily attributable to operating losses and overhead costs. Net cash provided by operating activities in the first nine months of 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. We plan to focus on expending our resources prudently given our current state of liquidity.

Net cash used by investing activities of $24,800 for the nine months ended September 30, 2010 primarily represented long-term deposits made under processing agreements. There were no cash flows generated by investing activities for the nine months ended September 30, 2009.

There were no cash flows generated by financing activities for either the nine months ended September 30, 2010 or 2009.

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 September 30, 2010 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 September 30, 2010 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 we recognized a loss on margin loans we guaranteed 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 from Mr. Long and 352,658 shares of our common stock valued at $12,343 from Mr. Hoch, in partial satisfaction of their annual payment for 2008 as provided for under their employment agreements. The partial payments made to us of $23,825 by Mr. Long and $12,343 by Mr. Hoch, equaled the difference between the amount each owed to us for the second installment and the amount that we owed to each for deferred salary. 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.

In December 2009, Mr. Long and Mr. Hoch did not pay us the third annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because we had partially deferred payment of their salary for 2009 called for under their respective employment agreements. At December 31, 2009, we owed deferred salary for 2009 of $162,385 to Mr. Long and $141,808 to Mr. Hoch, and were owed $133,825 by Mr. Long and $112,343 by Mr. Hoch, for the third installment due by December 31, 2009.

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. On or about January 1, 2009, Commerce Planet entered into an Asset Purchase Agreement with Morlex, Inc. Pursuant to this agreement, Commerce Planet’s liabilities were assigned to and/or assumed by Morlex, including the debt owed to us. On May 27, 2009, we commenced legal action against Morlex, Inc., in the 285th Judicial District Court of Bexar County, Texas. On September 2, 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 $7,500. We were also awarded all costs of Court and pre-judgment and post-judgment interest as provided by law.

On March 2, 2010, we entered into a settlement agreement with Commerce Planet, Inc. Under the terms of the settlement, Commerce Planet agreed to pay us $75,000 and issue 5,000,000 shares of Commerce Planet common stock to us on or before April 2, 2010. Additionally, both parties released all claims against each other. On March 2, 2010, we received payment of $75,000 from Commerce Planet in accordance with the terms of the settlement. On July 1, 2010, we were issued 5,000,000 shares of Commerce Planet common stock eligible for sale pursuant to Rule 144 under the terms of the settlement.

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ITEM 1A. RISK FACTORS.

As we disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2009, the issuing bank for our debit card programs is MetaBank, through its Meta Payment Systems® division with which we have a third party relationship agreement. On October 12, 2010, Meta Financial Group, Inc. filed a Form 8-K disclosing that its wholly owned subsidiary, MetaBank, is required, among other things, to obtain prior written approval from the Office of Thrift Supervision (“OTS”) before entering into any new third party relationship agreements concerning any credit product, deposit product (including prepaid access), or automatic teller machine pursuant to OTS supervisory directives. MetaBank sought such approvals for programs conducted through its Meta Payment Systems® division, and was informed on October 14, 2010 that OTS was not prepared at this time to allow MetaBank to enter into any such new third party relationship agreements. This means that MetaBank will not, without obtaining the prior written approval of OTS, be able to amend its existing agreements or enter into new agreements with distributors that are also parties to a third party agency relationship with MetaBank. This would include any distributors that have the capability to issue cards and accept cash deposits on those cards. According to the OTS, written permission to enter into all these types of programs must await the result of the OTS’ review of MetaBank’s operations, which review generally is not expected to occur for up to several months. Nonetheless, as currently disclosed, MetaBank expects to be able to continue to service its existing third party relationship agreements consistent with their terms and the OTS Directives, but can offer no assurance as to when or to what extent the OTS will allow MetaBank to resume adding new third party relationships.

If for any reason MetaBank was unable to continue to service its existing third party relationship agreement with us, it could require us to obtain another bank sponsor for our debit card programs in order to continue providing such services. We anticipate that this could have a material adverse effect on our results of operations and financial condition if we are unable to obtain another bank sponsor at similar costs.

There have been no other material changes from risk factors previously disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2009.

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

During the quarter ended September 30, 2010, we did not sell any unregistered securities.

On November 4, 2010, Michael Long, Chief Executive Officer and Chief Financial Officer, and Louis Hoch, President and Chief Operating Officer, were each granted 5,400,000 shares of restricted common stock by the Company as an annual bonus valued at $216,000 pursuant to the terms of their respective employment agreements. The number of shares granted to each officer was based on the closing price of the common stock on October 15, 2010, which was $0.04 per share.

With respect to the sale of our common stock described above, we relied on the Section 4(2) exemption from securities registration under the federal securities laws for transactions not involving any public offering. No advertising or general solicitation was employed in offering the shares. The shares were issued to accredited investors. The shares were issued for investment purposes only and not for the purpose of resale or distribution, and the transfer thereof was appropriately restricted by us.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

During the quarter ended September 30, 2010, we did not default on any senior securities.

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 10.17 to the Form SB-2 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).

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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).
10.15	First Amendment to Employment Agreement between the Company and Michael R. Long, dated November 12, 2009 (included as exhibit 10.15 to the Form 10-Q filed November 16, 2009, and incorporated herein by reference).
10.16	First Amendment to Employment Agreement between the Company and Louis A. Hoch, dated November 12, 2009 (included as exhibit 10.16 to the Form 10-Q filed November 16, 2009, and incorporated herein by reference).
10.17	Second Amendment to Employment Agreement between the Company and Michael R. Long, dated April 12, 2010 (included as exhibit 10.16 to the Form 10-K filed April 15, 2010, and incorporated herein by reference).
10.18	Second Amendment to Employment Agreement between the Company and Louis A. Hoch, dated April 12, 2010 (included as exhibit 10.17 to the Form 10-K filed April 15, 2010, 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: November 15, 2010	By:	/s/ Michael R. Long Name: Michael R. Long Chairman of the Board, Chief Executive Officer and Chief Financial Officer (principal executive officer and principal financial and accounting officer)