

PAYMENT DATA SYSTEMS INC
Form 10-Q
August 20, 2012

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

or

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.)
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12500 San Pedro, Ste. 120, San Antonio, TX (Address of principal executive offices)	78216 (Zip Code)
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(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. Yes 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). Yes No

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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	<input type="radio"/>	Accelerated filer	<input type="radio"/>
Non-accelerated filer	<input type="radio"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="radio"/>

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

As of August 13, 2012, 142,721,077 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

	June 30, 2012 (Unaudited)	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	\$1,896,487	\$3,678,688
Accounts receivable, net	275,368	376,070
Prepaid expenses and other	45,347	32,164
Total current assets	2,217,202	4,086,922
Property and equipment, net	23,269	4,234
Other assets:		
Related party receivable	702,337	702,337
Marketable securities	59,636	74,787
Other assets	32,693	41,693
Total other assets	794,666	818,817
Total assets	\$3,035,137	\$4,909,973
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$135,609	\$43,375
Accrued expenses	546,024	521,808
Customer deposits payable	1,249,599	3,429,135
Line of credit	139,695	300,000
Deferred revenue	5,141	4,348
Total current liabilities	2,076,068	4,298,666
Stockholders' equity:		
Common stock, \$0.001 par value, 200,000,000 shares authorized; 142,721,077 issued and 137,725,833 outstanding at June 30, 2012 (unaudited) and December 31, 2011, respectively	142,721	142,721
Additional paid-in capital	56,328,423	56,328,423
Treasury stock, at cost; 4,995,244 shares	(238,158)	(238,158)
Deferred compensation	(1,107,496)	(1,281,880)
Accumulated deficit	(54,166,421)	(54,339,799)
Total stockholders' equity	959,069	611,307
Total liabilities and stockholders' equity	\$3,035,137	\$4,909,973

See notes to interim consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Revenues	\$1,469,702	\$768,359	\$2,765,571	\$1,553,620
Operating expenses:				
Cost of services	908,093	598,542	1,680,471	1,209,502
Selling, general and administrative:				
Stock-based compensation	87,192	87,192	174,384	174,384
Other expenses	338,365	250,637	715,252	480,490
Depreciation	1,179	1,072	1,610	2,345
Total operating expenses	1,334,829	937,443	2,571,717	1,866,721
Operating income (loss)	134,873	(169,084)	193,854	(313,101)
Other income (expense):				
Unrealized (loss) on marketable securities	(15,151)	(91,738)	(15,151)	(91,738)
Other income (expense)	(416)	22,341	9,675	22,341
Total other income (expense), net	(15,567)	(69,397)	(5,476)	(69,397)
Income (loss) before income taxes	119,306	(238,481)	188,378	(382,498)
Income taxes	15,000	-	15,000	-
Net income (loss)	\$104,306	\$(238,481)	\$173,378	\$(382,498)
Basic and diluted earnings (net loss) per common share:	\$0.00	\$0.00	\$0.00	\$0.00
Weighted average common shares outstanding				
Basic	137,725,833	136,851,933	137,725,833	136,569,700
Diluted	137,725,833	136,851,933	137,725,833	136,569,700

See notes to interim consolidated financial statements.

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

	Six Months Ended June	
	30,	
	2012	2011
Operating activities:		
Net income (loss)	\$ 173,378	\$(382,498)
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:		
Issuance of stock for services provided	-	35,000
Unrealized loss on marketable securities	15,151	91,738
Depreciation	1,610	2,345
Non-cash stock based compensation	174,384	174,384
Changes in current assets and current liabilities:		
Accounts receivable	100,702	(37,129)
Prepaid expenses and other	(13,183)	(11)
Accounts payable and accrued expenses	116,450	(24,545)
Customer deposits payable	(2,179,536)	(504,715)
Deferred revenue	793	(9,607)
Net cash (used) by operating activities:	(1,610,251)	(655,038)
Investing activities:		
Purchases of property and equipment	(20,645)	(2,690)
Other assets	9,000	(2,500)
Net cash (used) by investing activities:	(11,645)	(5,190)
Financing activities:		
Proceeds from debt	479,405	-
Payments on debt	(639,710)	-
Net cash (used) by financing activities:	(160,305)	-
Change in cash and cash equivalents	(1,782,201)	(660,228)
Cash and cash equivalents, beginning of period	3,678,688	978,699
Cash and cash equivalents, end of period	\$ 1,896,487	\$ 318,471

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Payment Data Systems, Inc. and its subsidiaries (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 interim 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, 2011, filed April 3, 2012. 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 June 30, 2012, 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, as well as the daily trading volume of a security relative to the Company's ownership position.

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.

Certain amounts for 2011 have been reclassified for comparative purposes for 2012.

Note 2. Accrued Expenses

Accrued expenses consist of the following balances:

	June 30, 2012	December 31, 2011
Accrued salaries	\$230,997	\$135,768
Reserve for merchant losses	131,544	131,544
Accrued commissions	88,463	132,798
Accrued taxes	37,295	40,319
Other accrued expenses	57,725	81,379
Total accrued expenses	\$546,024	\$521,808

Note 3. Equity Line of Credit

On August 21, 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, at its election, the Company may receive as much as

\$10 million in common stock purchases by Dutchess over a period of five years. The Company agreed to file with the Securities and Exchange Commission (“SEC”), and have declared effective before any funds may be received under the agreement, a registration statement registering the resale of the shares of the Company’s common stock to be issued to Dutchess. The Company filed a registration statement on Form SB-2 with the SEC on August 23, 2007 to register the resale of these shares. On September 10, 2007, the SEC declared the registration statement effective. The Company did not sell any shares of its common stock pursuant to the equity line of credit during 2012, 2011 or 2010. Management does not currently expect to renew the agreement upon its termination on September 10, 2012.

Note 4. Line of Credit

In November 2011, the Company secured a line of credit that provides a maximum borrowing of \$500,000 and which matures on November 16, 2012. The credit line bears interest at 2.25% and is collateralized by a \$500,000 certificate of deposit. Outstanding borrowings under the credit line totaled \$139,695 as of June 30, 2012 and \$300,000 as of December 31, 2011.

Note 5. Net Income (Loss) Per Share

Basic earnings per share (EPS) were computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted EPS differs from basic EPS due to the assumed conversion of potentially dilutive options that were 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. There were no dilutive securities which were required to be included in the computation of weighted average number of shares outstanding at June 30, 2012. The following is a reconciliation of the numerators and the denominators of the basic and diluted per share computations for net income.

	Three Months Ended June 30,		Six Months Ended June 30	
	2012	2011	2012	2011
Numerator:				
Numerator for basic and diluted earnings per share, net income (loss) available to common shareholders	\$ 104,306	\$(238,481)	\$ 173,378	\$(382,498)
Denominator:				
Denominator for basic earnings per share, weighted average shares outstanding	137,725,833	136,851,933	137,725,833	136,569,700
Effect of dilutive securities	-	-	-	-
Denominator for diluted earnings per share, adjusted weighted average shares and assumed conversion	137,725,833	136,851,933	137,725,833	136,569,700
Basic earnings (loss) per common share	\$0.00	\$(0.00)	\$0.00	\$(0.00)
Diluted earnings (loss) per common share and common share equivalent	\$0.00	\$(0.00)	\$0.00	\$(0.00)

Note 6. 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;

2:

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

3:

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.

Recurring Fair Value Measures	At June 30, 2012			Total
	Level 1	Level 2	Level 3	
Assets:				
Marketable securities	\$59,636	\$-	\$-	\$59,636
Liabilities:				
None	\$-	\$-	\$-	\$-
Recurring Fair Value Measures	At December 31, 2011			Total
	Level 1	Level 2	Level 3	
Assets:				
Marketable securities	\$74,787	\$-	\$-	\$74,787
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 7. 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 current Chief Executive Officer and Chief Financial Officer; and Louis A. Hoch, the Company's President and Chief Operating Officer, in the amounts of \$535,302 and \$449,371, respectively. In February 2007, the Company signed employment agreements with Mr. Long and Mr. Hoch that required 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 respective 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 salaries 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 of their loan repayments. The total amount owed to the Company for the second installment was \$246,168 and is classified as "Related Party Receivable" on the Company's balance sheet at 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 payments 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 salaries. 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.

On November 12, 2009, the Company executed amendments to its employment agreements with Mr. Long and Mr. Hoch. Under the terms of their respective amended employment agreements, Mr. Long and Mr. Hoch agreed to reduce their annual base salaries for 2009 to \$190,000 and \$175,000, respectively, from \$375,000 and \$350,000, respectively.

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 salaries 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 of their loan repayments. The total amount owed to the Company for the unpaid installments was \$456,168 and was classified as "Related Party Receivable" on the Company's balance sheet at December 31, 2009.

On April 12, 2010, the Company executed a second amendment to its employment agreements with Mr. Long and Mr. Hoch. Under the terms of the second amendment to 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 to change their annual bonus limit from 100% of current salary to 100% of the highest salary received in any year of the agreement.

In December 2010, Mr. Long and Mr. Hoch did not pay the Company the fourth and final annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because the Company continued to be unable to pay the deferred salaries that were called for under their respective employment agreements. At December 31, 2010, the Company owed Mr. Long and Mr. Hoch deferred salaries of \$147,368 and \$126,915, respectively, in regards to their 2009 deferred salary balances. As of December 31, 2010, Mr. Long and Mr. Hoch owed the Company \$133,825 and \$112,343, respectively, for the fourth and final installment of their loan repayments. The total amount owed to the Company for the unpaid installments was classified as "Related Party Receivable" on the Company's balance sheet and was \$702,337 and \$703,060 is at December 31, 2011 and 2010, respectively.

On January 14, 2011, the Company executed a third amendment to its employment agreements with Mr. Long and Mr. Hoch. Under the terms of the third amendment to their respective employment agreements, Mr. Long and Mr. Hoch agreed to reduce their annual base salaries for 2011 to \$24,000 and \$24,000, respectively, from \$375,000 and \$350,000, respectively.

At December 31, 2011, the Company owed Mr. Long and Mr. Hoch a total of \$23,473 and \$3,300, respectively, in regards to their 2010 deferred salary balances, which were included in accrued expenses on the Company's balance sheet. The Company paid the obligations in the first quarter of 2012 and thus, the Company's balance sheet at June 30, 2012 did not reflect any such amounts owed at June 30, 2012.

As of June 30, 2012, Mr. Long owed the Company \$377,651 and Mr. Hoch owed the Company \$324,686. The total amount for the unpaid installments of \$702,337 is classified as "Related Party Receivable" on the Company's balance sheet at June 30, 2012.

On July 2, 2012, the Company executed a fourth amendment to its employment agreements with Mr. Long and Mr. Hoch. Under the terms of the fourth amendment to their respective employment agreements, Mr. Long and Mr. Hoch agreed to amend their annual base salaries for 2012 to \$255,000 and \$235,000, respectively, from \$375,000 and \$350,000, respectively.

During the six months ended June 30, 2012 and the year ended December 31, 2011, the Company paid Herb Authier a total of \$15,000 and \$30,000 in cash, respectively, for services related to network engineering and administration that

he provided to the Company. Mr. Authier is the father-in-law of Louis Hoch, the Company's President and Chief Operating Officer.

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

FORWARD-LOOKING STATEMENTS DISCLAIMER

This Quarterly 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, 2011, filed April 3, 2012.

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 Clearing House network. We also operate an online payment processing service for consumers under the domain name www.billx.com through which consumers can pay anyone. We offer MasterCard prepaid cards that can be branded with a corporate logo or message. The prepaid cards can be used for various purposes including payroll, corporate incentives, employee incentives, and general use. Depending on the established guidelines of the prepaid card program, which are individually designed to fit the corporation's needs, the prepaid card may be reloadable or may be able to be used at Automatic Teller Machines to withdraw cash.

We incurred operating losses each quarter from inception through June 30, 2011. However, we recorded both operating income and net income in the third and fourth quarters of 2011 and have continued to maintain profitability in the first and second quarters of 2012 due primarily to our expanded client base and associated increased transaction volumes. To maintain our profitability 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 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 to outsource some of our processing services to third parties to allow us to maintain an efficient operating infrastructure and to 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 ongoing 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 is recognized as revenue during 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 as gross of amounts paid to sponsor banks as well as interchange and assessments paid to credit card associations (MasterCard, Visa and Discover). 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 Merchant Accounts

If, due to insolvency or bankruptcy of the merchant, or for any other reason, we are unable 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 its consumers. This reserve amount is subject to the risk that actual losses may be greater than our estimates. At June 30, 2012 and December 31, 2011, our card merchant processing loss reserve was \$131,544. 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. At June 30, 2012, the balance of the allowance for doubtful accounts was approximately \$78,000. If the financial conditions of our customers were to deteriorate, resulting in an impairment of their ability to make contractual payments, additional allowances might be required. Our estimate for bad debt losses is likely to increase in the future as our volume of transactions processed increases.

Marketable Securities

We classify our marketable security investment portfolio as either held to maturity, available-for-sale, or trading. At June 30, 2012, all our 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, as well as the daily trading volume of a security relative to our ownership position. Gains or losses from the sale or redemption of the marketable securities are determined using the specific identification method.

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 2011 or during the six months ended June 30, 2012.

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, 2012 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, 2011, we had available net operating loss carryforwards of approximately \$44 million, which expire beginning in the year 2020. Approximately \$3.5 million of the total net operating loss is subject to an IRS Section 382 limitation from 1999.

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 Clearing House network, or ACH, and the program management and processing of prepaid debit cards. 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, 2012 increased 91% to \$1,469,702, as compared to \$768,359 for the quarter ended June 30, 2011. Revenues for the six months ended June 30, 2012 increased 78% to \$2,765,571 as compared to \$1,553,620 for the six months ended June 30, 2011. The increases for the three and six months ended June 30, 2012 as compared to the same periods in the prior year were primarily attributed to an increase in the number of our customers and the associated increased transaction volume from card-based and ACH processing services.

Cost of services includes the cost of personnel dedicated to the creation and maintenance of connections to third-party payment processors and the fees paid to such third-party providers for electronic payment processing services. Through our contractual relationships with our payment processors and sponsoring banks, we are able to process ACH and debit, credit or prepaid card transactions on behalf of our customers and their consumers. We pay volume-based fees for debit, credit, ACH and prepaid transactions initiated through these processors or sponsoring banks, and pay fees for other transactions such as returns, notices of change to bank accounts and file transmission. Cost of services increased 52% to \$908,093 for the quarter ended June 30, 2012, as compared to \$598,542 for the same period in the prior year. Cost of services increased 39% to 1,680,471 for the six months ended June 30, 2012 as compared to \$1,209,502 for the same period in the prior year. The increases for the three and six months ended June 30, 2012 as compared to the same periods in the prior year were primarily due to the increase in variable costs related to processing the increased card-based and ACH transaction volume and the accrual of annual bonuses required by executive employee agreements.

Stock-based compensation expenses were \$87,192 and \$174,384 for the three and six months ended June 30, 2012 and for the same periods in 2011. These amounts represent the amortization of deferred compensation expenses

related to incentive stock grants to employees.

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Selling, general and administrative expenses increased 35% to \$338,365 for the quarter ended June 30, 2012, compared to \$250,637 for the same period in the prior year, and increased 49% to \$715,252 for the six months ended June 30, 2012 as compared to \$480,490 the for the same period in the prior year. The increases for the three and six months ended June 30, 2012 as compared to the same periods in the prior year were principally due to higher salary expenses incurred.

Depreciation expenses were \$1,179 and \$1,610 for the quarter and six months ended June 30, 2012, compared to \$1,072 and \$2,345 for the same periods in the prior year.

Total other income (expense), net, were expenses of \$15,567 and \$5,476 for the quarter and six months ended June 30, 2012 and primarily represented a \$15,151 unrealized loss on our marketable securities. Total other income (expense), net was an expense of \$69,397 for the three months and six months ended June 30, 2011, respectively, and represented a \$91,738 unrealized loss on our marketable securities offset by income of \$22,341 resulting from a reduction in commissions payable.

We reported net income of \$104,306 and \$173,378 for the quarter and six months ended June 30, 2012, compared to net losses of \$238,481 and \$382,498 for the same periods in the prior year, as a result of the items discussed above.

Liquidity and Capital Resources

At June 30, 2012, we had \$1,896,487 of cash and cash equivalents, compared to \$3,678,688 of cash and cash equivalents at December 31, 2011. These cash balances included a \$500,000 certificate of deposit which collateralizes our line of credit as described in more detail below. We incurred substantial losses from inception through June 30, 2011 however, we recorded net income in the third and fourth quarters of 2011 and have continued to remain profitable in the first and second quarters of 2012. Our working capital deficit decreased to \$211,744 at December 31, 2011, and we reported positive working capital of \$141,134 at June 30, 2012. We believe our expanded client base and associated increased transaction volumes will continue to provide sufficient cash for business operations for the foreseeable future.

In November 2011, we secured a line of credit that provides a maximum borrowing of \$500,000 and which matures on November 16, 2012. The credit line bears interest at 2.25% and is collateralized by a \$500,000 certificate of deposit. Outstanding borrowings under the credit line totaled \$139,695 as of June 30, 2012 and \$300,000 as of December 31, 2011.

On August 21, 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 September 10, 2012. From January 1, through June 30, 2012, we did not sell any shares under the agreement.

Net cash used by operating activities was \$1,610,251 for the six months ended June 30, 2012 compared to \$655,038 for the same period in the prior year. The increase in net cash used by operating activities for the six months ended June 30, 2012 as compared to the same period of the prior year was primarily attributable to a \$2,179,536 decrease in customer deposit payables, which consisted of cash held in transit that we collected on behalf of our merchants via the ACH, as compared to a \$504,715 decrease in customer deposit payables for the same period in the prior year.

Net cash used by investing activities was \$11,645 for the six months ended June 30, 2012 compared to \$5,190 for the same period in the prior year, and primarily consisted of changes in long-term deposits made under processing agreements as well as minor purchases of property and equipment in 2012.

Net cash used by financing activities was \$160,305 for the six months ended June 30, 2012 and represented the repayment of the balance outstanding under the line of credit at December 31, 2011 net of additional borrowing in the second quarter of 2012. There were no cash flows generated by or used by financing activities for the same period in the prior year.

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 4. 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, 2012 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 evaluation of disclosure controls and procedures included an evaluation of certain 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, 2012 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.

From time to time, we may become involved in various lawsuits and legal proceedings that arise in the ordinary course of business. We are currently not aware of any such legal proceedings or claims against us or our officers and directors in their capacity as such that we believe will have, individually or in the aggregate, a material adverse effect on our business, financial condition or operating results.

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, 2011, as filed with the Securities and Exchange Commission on April 3, 2012.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

During the quarter ended June 30, 2012, we did not default on any senior securities.

ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable.

ITEM 5. OTHER INFORMATION.

Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers.

We entered into an employment agreement with Michael R. Long effective February 27, 2007. Under the agreement, Mr. Long serves as our Chairman of the Board, Chief Executive Officer and Chief Financial Officer. The agreement provides for base annual salaries of \$190,000 for 2007, \$300,000 for 2008 and \$375,000 for the years 2009, 2010, 2011, and 2012. On July 2, 2012, we executed a fourth amendment to our employment agreement with Mr. Long, where he agreed to reduce his annual base salary for 2012 to \$255,000 from \$375,000, and to amend his annual bonus compensation to be \$216,000, payable as of November 1st of each year during the term of our agreement with Mr. Long, with the exception of fiscal year 2012 whereby Mr. Long will receive a bonus of \$54,000. The annual bonus compensation may be paid, at our sole discretion, in either cash or in shares of common stock, with the exception of fiscal year 2012 whereby it was agreed Mr. Long would receive cash. If we pay such bonus compensation in the form of shares of common stock, the number of shares to be issued shall be based upon the closing price of our common stock as of October 15th (or the last trading day prior to October 15th) of the year the bonus is due to be paid.

We entered into an employment agreement with Louis A. Hoch effective February 27, 2007. Under the agreement, Mr. Hoch serves as our Vice Chairman of the Board, President and Chief Operating Officer. The agreement provides for base annual salaries of \$175,000 for 2007, \$275,000 for 2008 and \$350,000 for the years 2009, 2010, 2011, and 2012. On July 2, 2012, we executed a fourth amendment to our employment agreement with Mr. Hoch, where he agreed to reduce his annual base salary for 2012 to \$235,000 from \$350,000, and to amend his annual bonus compensation to be \$216,000, payable as of November 1st of each year during the term of our agreement with Mr.

Hoch, with the exception of fiscal year 2012 whereby Mr. Hoch will receive a bonus of \$54,000. The annual bonus compensation may be paid, at our sole discretion, in either cash or in shares of common stock, with the exception of fiscal year 2012 whereby it was agreed Mr. Hoch would receive cash. If we pay such bonus compensation in the form of shares of common stock, the number of shares to be issued shall be based upon the closing price of our common stock as of October 15th (or the last trading day prior to October 15th) of the year the bonus is due to be paid

ITEM 6. EXHIBITS.

Exhibit Number	Description
3.1	Amended and Restated Articles of Incorporation of Payment Data Systems, Inc. (included as Exhibit 3.1 to the Form 10-KSB filed March 31, 2006, and incorporated herein by reference).
3.2	Amended and Restated Bylaws of Payment Data Systems, Inc. (included as Exhibit 3.2 to the Form 10-KSB filed March 31, 2006, and incorporated herein by reference).
3.3	Articles of Amendment to the Amended and Restated Articles of Incorporation of Payment Data Systems, Inc. (included as Exhibit A to the Schedule 14C filed April 18, 2007, and incorporated herein by reference).
4.1	Employee Stock Purchase Plan (included as Exhibit 4.3 to the Form S-8, File No. 333-30958, filed February 23, 2000, and incorporated herein by reference).
4.2	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	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).
10.5	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).
10.6	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).
10.7	Amended Investment Agreement between the Company and Dutchess Private Equities Fund, Ltd., dated August 21, 2007 (included as Exhibit 10.16 to the Form SB-2 filed August 23, 2007, and incorporated herein by reference).
10.8	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).
10.9	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).

10.10	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).
10.11	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).
10.12	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).
10.13	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).
10.14	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).
10.15	Bank Sponsorship Agreement between the Company and University National Bank, dated August 29, 2011 (included as Exhibit 10.18 to the Form 10-K filed April 3, 2012, and incorporated herein by reference).
10.16	Third Amendment to Employment Agreement between the Company and Michael R. Long, dated January 14, 2011 (included as Exhibit 10.19 to the Form 10-K filed April 3, 2012, and incorporated herein by reference).
10.17	Third Amendment to Employment Agreement between the Company and Louis A. Hoch, dated January 14, 2011 (included as Exhibit 10.20 to the Form 10-K filed April 3, 2012, and incorporated herein by reference).
10.18	Fourth Amendment to Employment Agreement between the Company and Michael R. Long, dated July 2, 2012 (filed herewith).
10.19	Fourth Amendment to Employment Agreement between the Company and Louis A. Hoch, dated July 2, 2012 (filed herewith).
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).
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Presentation Linkbase Document

*Pursuant to Rule 405(a)(2) of Regulation S-T, the Company will furnish the XBRL Interactive Data Files with detailed footnote tagging as Exhibit 101 in an amendment to this Form 10-Q within the permitted 30-day grace period for the first quarterly period in which detailed footnote tagging is required after the filing date of this Form 10-Q.

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 20, 2012

By: /s/ Michael R. Long
Michael R. Long
Chief Executive Officer and Chief
Financial Officer
(Principal Executive Officer, and
Principal Financial and Accounting
Officer)