PAYMENT DATA SYSTEMS INC
Form 10-Q
August 14, 2014

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

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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.)
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. 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

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

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

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 8, 2014, 137,224,398 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, 2014 (Unaudited)	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$ 60,790,124	$ 26,573,771
Accounts receivable, net	887,481	585,037
Prepaid expenses and other	101,614	98,966
Total current assets	61,779,219	27,257,774
Property and equipment, net	131,683	122,061
Other assets:		
Marketable securities	32,835	27,450
Other assets	165,771	121,144
Total other assets	198,606	148,594
Total assets	$ 62,109,508	$ 27,528,429
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 27,113	$ 60,818
Accrued expenses	1,154,759	1,088,644
Customer deposits payable	59,489,302	25,740,163
Total current liabilities	60,671,174	26,889,625
Stockholders' equity:		
Common stock, $0.001 par value, 200,000,000 shares authorized; 147,795,152 and 147,721,077 issued, and 137,224,398 and 137,150,323 outstanding at June 30, 2014 (unaudited) and December 31, 2013, respectively	147,795	147,721
Additional paid-in capital	56,878,349	56,873,423
Treasury stock, at cost; 10,570,754 and 10,570,754 shares	(1,241,750)	(1,241,750)
Deferred compensation	(1,140,980)	(1,286,970)
Accumulated deficit	(53,205,080)	(53,853,620)
Total stockholders' equity	1,438,334	638,804
Total liabilities and stockholders' equity	$ 62,109,508	$ 27, 528,429

See notes to interim consolidated financial statements.

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

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Revenues	$3,304,173	$930,830	$6,034,996	$1,990,333
Operating expenses:				
Cost of services	2,349,268	823,788	4,441,294	1,650,088
Selling, general and administrative:				
Stock-based compensation	72,995	73,270	150,990	146,540
Other expenses	404,825	348,085	785,258	724,385
Depreciation	10,706	7,587	20,611	13,878
Total operating expenses	2,837,794	1,252,730	5,398,153	2,534,891
Operating income (loss)	466,379	(321,900)	636,843	(544,558)
Other income and (expense):				
Interest income	22,424	97	29,238	573
Other income (expense)	8,593	62,319	5,233	52,070
Total other income and (expense),net	31,017	62,416	34,471	52,643
Income (loss) before income taxes	497,396	(259,484)	671,314	(491,915)
Income taxes	10,595	7,000	22,774	7,000
Net income (loss)	$486,801	$(266,484)	$648,540	$(498,915)
Basic earnings (loss) per common share:	$0.00	$0.00	$0.01	$0.00
Diluted earnings (loss) per common share:	$0.00	$0.00	$0.00	$0.00
Weighted average common shares outstanding				
Basic	125,014,549	131,331,572	125,009,229	131,331,572
Diluted	132,833,380	131,331,572	132,555,239	131,331,572

See notes to interim consolidated financial statements.

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

	Six Months Ended June 30,	
	2014	2013
Operating activities:		
Net income (loss)	$648,540	$(498,915)
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:		
Unrealized (gain) on marketable securities	(5,384)	(52,070)
Depreciation	20,611	13,878
Non-cash stock based compensation	150,990	146,540
Changes in current assets and current liabilities:		
Accounts receivable	(302,444)	312,918
Prepaid expenses and other	(2,648)	56,749
Other assets	(44,627)	(61,329)
Accounts payable and accrued expenses	32,410	(280,348)
Customer deposits payable	33,749,138	(686,226)
Deferred revenue	-	(3,325)
Net cash provided (used) by operating activities:	34,246,586	(1,052,128)
Investing activities:		
Purchases of property and equipment	(30,233)	(56,733)
Purchases of treasury stock	-	(301,255)
Net cash (used) by investing activities:	(30,233)	(357,988)
Change in cash and cash equivalents	34,216,353	(1,410,116)
Cash and cash equivalents, beginning of period	26,573,771	3,759,791
Cash and cash equivalents, end of period	$60,790,124	$2,349,675
Non-cash item:		
Settlement of related party receivable with treasury stock	$-	$702,337

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, 2013, as filed with the Securities and Exchange Commission on March 31, 2014. 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.

Cash and Cash Equivalents: Cash and cash equivalents includes cash and other money market instruments. The Company considers all highly liquid investments with an original maturity of ninety days or less to be cash equivalents. Cash also includes customer deposits.

Marketable Securities: The Company classifies its marketable security investment portfolio as either held to maturity, available-for-sale, or trading. At June 30, 2014, 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. Gains or losses from the sale or redemption of the marketable securities are determined using the specific identification method.

Customer Deposits: Customer deposits include security deposits that may be required by the Company from certain customers and cash held in transit that we collected on behalf of all our customers via our ACH processing service. The security deposit is used to offset any returned items or chargebacks to the Company and to indemnify the Company against third-party claims and any expenses that may be created by the customer as a result of any claim or fine. The customer deposit may be revised by the Company based on periodic review of transaction volumes, amounts and chargebacks. Repayment of the deposit to the customer is generally within 90 to 180 days beyond the date the last item is processed by the Company on behalf of the customer. The customer security deposit does not accrue interest to the benefit of the customer.

Estimates: The preparation of financial statements in conformity with U.S. 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.

New Accounting Pronouncement: In May 2014, the Financial Accounting Standards Board issued a new accounting pronouncement regarding revenue from contracts with customers. This new standard provides guidance on recognizing revenue, including a five step model to determine when revenue recognition is appropriate. The standard requires that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Adoption of the new standard is effective for reporting periods beginning after December 15, 2016, with early adoption not permitted. The Company is currently evaluating the potential impact that the adoption of this standard will have on its financial position, results of operations, and related disclosures, and will adopt the provisions of this new standard in the first quarter of 2017.

Note 2. Accrued Expenses

Accrued expenses consisted of the following balances:

	June 30, 2014	December 31, 2013
Accrued salaries	$140,043	$142,071
Reserve for processing losses	297,365	297,365
Accrued commissions	492,714	350,188
Accrued taxes	22,624	51,820
Other accrued expenses	202,013	247,200
Total accrued expenses	$1,154,759	$1,088,644

Note 3. 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 awards and options that were outstanding during the period. The following is a reconciliation of the numerators and the denominators of the basic and diluted per share computations for net income (loss) for the three and six months ended June 30, 2014 and 2013.

	Three Months Ended June 30,		Six Months Ended June 30	
	2014	2013	2014	2013
Numerator:				
Numerator for basic and diluted earnings per share, net income (loss) available to common shareholders	$486,801	$(266,484)	$648,540	$(498,915)
Denominator:				
Denominator for basic earnings per share, weighted average shares outstanding	125,014,549	131,331,572	125,009,229	131,331,572
Effect of dilutive securities	7,818,831	-	7,546,010	-
Denominator for diluted earnings per share, adjusted weighted average shares and assumed conversion	132,833,380	131,331,572	132,555,239	131,331,572
Basic earnings (loss) per common share	$0.00	$0.00	$0.01	$0.00
Diluted earnings (loss) per common share and common share equivalent	$0.00	$0.00	$0.00	$0.00

The awards and options to purchase shares of common stock that were outstanding for the three months ended June 30, 2014 and 2013 and were not included in the computation of diluted earnings per share because the effect would have been anti-dilutive are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Numerator:				
Anti-dilutive awards and options	-	10,959,270	-	10,959,270

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Note 4. 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.

	June 30, 2014			
Recurring Fair Value Measures Assets:	Level 1	Level 2	Level 3	Total
Marketable securities	$ 32,835	-	-	$ 32,835
Liabilities:				
None	-	-	-	-

	December 31, 2013			
Recurring Fair Value Measures Assets:	Level 1	Level 2	Level 3	Level 1
Marketable securities	$ 27,450	-	-	$ 27,450
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 5. Related Party Transactions

Mr. Michael R. Long and Louis A. Hoch

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 the Company’s 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.

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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 of their loan repayments and the amount the Company owed to each executive as 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.

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 to the Company's continued inability 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 December 31, 2012 did not reflect any such amounts owed at December 31, 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.

As of December 31, 2012, Mr. Long owed the Company $377,651 and Mr. Hoch owed the Company $324,686.
On March 11, 2013, in accordance with the Company's employment agreements with Mr. Long and Mr. Hoch, the Company accepted shares of the Company's common stock owned by Mr. Long and Mr. Hoch as satisfaction in full for the remaining amounts owed to the Company as annual payments due to the loss on margin loans guaranteed by the Company for Mr. Long and Mr. Hoch.

On March 11, 2013, the Company also agreed to purchase additional shares of its common stock owned by Mr. Long and Mr. Hoch, valued at $156,852 and $144,403, respectively, in lieu of the issuances of cash bonuses to Mr. Long and Mr. Hoch. Such bonuses were intended to compensate the executives for their service. As a result, the Company incurred a one-time reduction in cash of $301,255.

Accordingly, on March 11, 2013, the Company accepted an aggregate of 2,969,459 shares of the Company's common stock valued at $534,503, and an aggregate of 2,606,051 shares of the Company's common stock valued at $469,089 from Mr. Long and Mr. Hoch, respectively, as satisfaction in full of their aggregated outstanding amounts of $702,337 owed to the Company and aggregated compensation of $301,255 paid to Mr. Long and Mr. Hoch in lieu of cash bonuses. The common stock accepted from Mr. Long and Mr. Hoch was valued at $0.18 per share, which was the closing price of the common stock on March 1, 2013. The common stock accepted from Mr. Long and Mr. Hoch was recorded as treasury stock and the Company no longer carries a "Related Party Receivable" on its balance sheet.

Accordingly, following the completion of these transactions the Company has no remaining receivables or payables related to Mr. Long, Mr. Hoch or any other officer of the Company.

Herb Authier

During the six months ended June 30, 2014 and the year ended December 31, 2013, the Company paid Herb Authier a total of $20,500 and $35,400 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, 2013, filed March 31, 2014, including the audited consolidated financial statements and the notes contained therein.

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, under the domain name www.billx.com system, which allows consumers to process online payments to pay any other individual, including family and friends.

Since our inception in 1998, we incurred operating losses each quarter until the quarter ended June 30, 2011. We generated both operating income and net income in the third and fourth quarters of 2011 and were profitable for all four quarters of 2012. Despite our recent profitability in the first two quarters of 2014 and our profitability in the fourth quarter of 2013, we reported a net loss of $789,039 for the year ended December 31, 2013. At December 31, 2013, our accumulated deficit was $53,853,620. We reported net income of $648,540 for the six months ended June 30, 2014 as compared with net loss of $498,915 for the same period last year. Credit card processing volumes for the second quarter of 2014 were the highest for any previous quarter in our history. Our credit card and debit card processing transactions for the second quarter of 2014 increased 14% over the same period in 2013 and our credit card and debit card dollars processed for the second quarter of 2014 increased 56% over the same period in 2013 resulting in record volumes. In the fourth quarter of 2013, we initiated Automatic Clearing House, or ACH, transaction processing for newly acquired customers that led to dramatic increases in ACH transaction volumes. ACH volumes reported for the fourth quarter of 2013 were the highest we had experienced at the time. This trend has continued into 2014.. ACH processing transactions for the second quarter of 2014 increased 45% and returned check transactions processed increased 27% as compared to the first quarter of 2014. The increases in credit and debit processing combined with the increases in ACH Processing also led to record revenues compared to any previous quarter in our history. We believe these trends will continue for the foreseeable future. We also expect to see an increase in the number of our enrolled merchant customers, for whom we provide processing for credit and debit card transactions, and we expect to add new clients to our sales pipeline, which we believe will create increased transaction volumes.

We believe the profitability we experienced in the first and second quarters of 2014 will continue for the foreseeable future, but the extent of our future operating results and the ultimate timing of our profitability is not certain. We may continue to incur operating losses in the future. To sustain 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 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

Our 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, revenues 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, debit, and prepaid 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 (Visa, MasterCard 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 Processing Losses

If, due to insolvency or bankruptcy of one of our merchant customers, or for any other reason, we are not able to collect amounts from our credit card, ACH or prepaid customers that have been properly "charged back" by the customer, or if a prepaid cardholder incurs a negative balance, we must bear the credit risk for the full amount of the 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. ACH, prepaid and credit card merchant processing loss reserves are primarily determined by performing a historical analysis of our loss experience and considering other factors that could affect that experience in the future, such as the types of transactions processed and nature of the merchant relationship with its consumers and us with our prepaid card holders. This reserve amount is subject to the risk that actual losses may be greater than our estimates. We have not incurred any significant processing losses to date. Estimates for processing losses are variable based on the volume of transactions processed and could increase or decrease accordingly. At both June 30, 2014 and December 31, 2013, our reserve for processing losses was $297,365.

Customer Deposits

Customer deposits include security deposits that we may require for certain customers and cash held in transit that we collected on behalf of all of our customers via our ACH processing service. The security deposit is used to offset any returned items or chargebacks to us and to indemnify us against third-party claims and any expenses that may be created by the customer as a result of any claim or fine. We may revise the customer security deposit based on periodic review of transaction volumes, amounts and chargebacks. Repayment of the deposit to the customer is generally made within 90 to 180 days after the date on which the last item is processed by us. The security deposit does not accrue interest to the benefit of the customer.

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. 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. Estimates for bad debt losses are variable based on the volume of transactions processed and could increase or decrease accordingly. At June 30, 2014 and December 31, 2013, our allowance for doubtful accounts was $46,023 and $49,782, respectively.

Marketable Securities

We classify our marketable security investment portfolio as either held to maturity, available-for-sale, or trading. At June 30, 2014, all our marketable securities were classified as trading. Securities classified as trading are carried at fair value, with unrealized gains and losses included in the consolidated statement of income. Classification as current or non-current is based primarily on whether there is an active public market for such security. 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 periodically, or 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 2013 or during the six months ended June 30, 2014. Management is not aware of any impairment changes that may currently be required; however, we cannot predict the occurrence of events that might adversely affect the reported values in the future.

Income Taxes

Deferred tax assets and liabilities are recorded based on the difference between financial reporting and tax bases of assets and liabilities and are measured by the enacted tax rates and laws that are expected to 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, 2014 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, 2013, we had available net operating loss carryforwards of approximately $43.6 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.

U.S. generally accepted accounting principles prescribe a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Income tax benefits that meet the “more likely than not” recognition threshold should be recognized. We have not recorded any unrecognized income tax benefits at June 30, 2014. Management is not aware of any tax positions that would have a significant impact on our financial position.

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, or ACH, network 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, 2014 increased 255% to $3,304,173, as compared to $930,830 for the quarter ended June 30, 2013. Revenues for the six months ended June 30, 2014 increased 203% to $6,034,996, as compared to $1,990,333 for the six months ended June 30, 2013. The increases for the quarter and six months ended June 30, 2014, as compared to the same periods in the prior year, were primarily due to the increase in the volume of ACH transactions processed for our newly acquired customers.

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 185% to $2,349,268 for the quarter ended June 30, 2014, as compared to $823,788 for the same period in the prior year. Cost of services increased 169% to $4,441,294 for the six months ended June 30, 2014, as compared to $1,650,088 for the same period in the prior year. The increases for the quarter and six months ended June 30, 2014, as compared to the same periods in the prior year, were primarily due to the increase in the volume of transactions processed.

Stock-based compensation expenses were $72,995 and $150,990, respectively, for the quarter and six months ended June 30, 2014, and $73,270 and $146,540 for the same periods in the prior year. These stock-based compensation expenses represent the amortization of deferred compensation expenses related to incentive stock awards granted to employees.

Other expenses increased 16% to $404,825 for the quarter ended June 30, 2014, as compared to $348,085 for the same period in the prior year. The increase in other selling, general and administrative expenses for the quarter ended June 30, 2014, as compared to the same period in the prior year, represented an increase in employee bonus compensation. Other expenses increased 8% to $785,258 for the six months ended June 30, 2014, as compared to $724,385 for the same period in the prior year. The increase in other selling, general and administrative expenses for the six months ended June 30, 2014, as compared to the same period in the prior year, represented an increase in employee bonus compensation.

Depreciation expenses were $10,706 and $20,611 for the quarter and six months ended June 30, 2014, compared to $7,587 and $13,878 for the same periods in the prior year.

Other income (expense), net were incomes of $31,017 and $ 34,471 for the quarter and six months ended June 30, 2014 compared to incomes of $62,416 and $52,643 for the quarter and six months ended June 30, 2013. Other income (expense), net primarily represented interest income and unrealized gains on our marketable securities. Interest income was $22,424 and $29,238, respectively, for the quarter and six months ended June 30, 2014, as compared to $97 and $573 for the same periods in the prior year. The increases for the quarter and six months ended June 30, 2014, as compared to the same periods in the prior year were primarily due to the increase in interest earned on higher cash balances. Unrealized gains on our marketable securities were $8,593 and $5,233, respectively, for the quarter and six months ended June 30, 2014, as compared to $62,319 and $52,070 for the same periods in the prior year.

We reported net income of $486,801 and $648,540 for the quarter and six months ended June 30, 2014, as compared to net losses of $266,484 and $498,915 for the same period in the prior year.

Liquidity and Capital Resources

At June 30, 2014, we had $60,790,124 of cash and cash equivalents, as compared to $26,573,771 of cash and cash equivalents at December 31, 2013. The increase in cash for the six months ended June 30, 2014 was primarily due to customer deposit payables of $59,489,302, which represented an increase of $33,749,138 in customer deposit payables for 2014 that was directly associated with the increase in ACH transaction volumes for our newly acquired customers and the associated cash reserve requirements we placed on some of those customers.

Since our inception in 1998, we incurred operating losses each quarter until the quarter ended June 30, 2011. We generated both operating income and net income in the third and fourth quarters of 2011 and were profitable for all four quarters of 2012. Despite our recent profitability in the first two quarters of 2014 and our profitability in the fourth quarter of 2013, we reported a net loss of $789,039 for the year ended December 31, 2013. We reported net income of $648,540 for the six months ended June 30, 2014 as compared with net loss of $498,915 for the same period last year. Additionally, we reported working capital of $1,108,045 and $368,149 at June 30, 2014 and December 31, 2013, respectively.

Net cash provided by operating activities was $34,246,586 for the six months ended June 30, 2014, as compared to net cash used by operating activities of $1,052,128 for the same period in the prior year. The increase in net cash provided (used) by operating activities for the six months ended June 30, 2014 as compared to the same period in the prior year was primarily attributable to a $33,749,138 increase in customer deposit payables, which consisted of cash held in transit that we collected on behalf of our merchants via our ACH processing service, as compared to a $686,226 decrease in customer deposit payables for the same period in the prior year. In addition to the increase in customer deposits, this increase in net cash provided (used) by operating activities was also attributable to a net income of $648,540 for the six months ending June 30, 2014, as compared to a net loss of $498,915 for the same period in the prior year offset by an increase in accounts receivable of $302,444 for the six months ended June 30, 2014, as compared to a decrease in receivables of $312,918 for the same period in the prior year.

Net cash used by investing activities was $30,233 for the six months ended June 30, 2014, as compared to net cash used by investing activities of $357,988 for the same period in the prior year; the decrease in cash used for investing activities was primarily due the $301,255 used by us to purchase additional shares of common stock owned by Mr. Long and Mr. Hoch in the first quarter of 2013.

There were no cash flows from financing activities for the three months ended June 30, 2014 or June 30, 2013, respectively.

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, 2014 were 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 disclosure. 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, 2014 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 are involved in legal matters arising in the ordinary course of business. While we believe that such matters are currently not material, there can be no assurance that matters arising in the ordinary course of business for which we are or could become involved in litigation, will not have a material adverse effect on our business, financial condition or results of operations in the future..

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, 2013, as filed with the Securities and Exchange Commission on June 30, 2014.

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

During the quarter ended June 30, 2014, we did not issue or sell any unregistered equity securities.

Item 3. DEFAULTS UPON SENIOR SECURITIES.

Not applicable.

Item 4. MINE SAFETY DISCLOSURES.

Not applicable.

Item 5. OTHER INFORMATION.

None.

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	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).
10.5	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	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).
10.8	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).
10.9	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).

10.10	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).
10.11	Prepaid Card Program Agreement between FiCentive, Inc. 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).
10.12	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).
10.13	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).
10.14	Fourth Amendment to Employment Agreement between the Company and Michael R. Long, dated July 2, 2012 (included as Exhibit 10.18 to the Form 10-Q filed August 20, 2012, and incorporated herein by reference).
10.15	Fourth Amendment to Employment Agreement between the Company and Louis A. Hoch, dated July 2, 2012 (included as Exhibit 10.19 to the Form 10-Q filed August 20, 2012, and incorporated herein by reference).
10.16	Confidential Compromise Settlement Agreement and Full and Final Release by and between FiCentive, Inc. and SmartCard Marketing Systems, Inc., dated November 20, 2012 (included as Exhibit 10.1 to the Form 8-K filed November 29, 2012).
10.17	First Amendment to Lease Agreement dated August 22, 2003 between the Company and Frost National Bank, Trustee for a Designated Trust, dated February 6, 2006 (included as Exhibit 10.17 to the Form 10-K filed April 1, 2013, and incorporated herein by reference).
10.18	Second Amendment to Lease Agreement dated August 22, 2003 between the Company and Frost National Bank, Trustee for a Designated Trust, dated October 7, 2009 (included as Exhibit 10.18 to the Form 10-K filed April 1, 2013, and incorporated herein by reference).
10.19	Third Amendment to Lease Agreement dated August 22, 2003 between the Company and Frost National Bank, Trustee for a Designated Trust, dated October 12, 2013 (included as Exhibit 10.19 to the Form 10-K filed April 1, 2013, 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).
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document (filed herewith).
101.INS*	XBRL Instance Document (filed herewith).
101.SCH*	XBRL Taxonomy Extension Schema Document (filed herewith).
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document (filed herewith).
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document (filed herewith).

101.PRE*	XBRL Taxonomy Presentation Linkbase Document (filed herewith).

* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURE

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

PAYMENT DATA SYSTEMS, INC.

Date: August 14, 2014	By:	/s/ Michael R. Long Michael R. Long Chief Executive Officer and Chief Financial Officer Principal Executive Officer, and Principal Financial and Accounting Officer)