PAYMENT DATA SYSTEMS INC
Form 10QSB
August 14, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2007

OR

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from ____ to ____

Commission file number 000-30152

Payment Data Systems, Inc.
(Exact name of small business issuer as specified in its charter)

Nevada	**98-0190072**

(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

12500 San Pedro, Suite 120

San Antonio, TX 78216

(Address of principal executive offices)

(210) 249-4100

(Issuer s telephone number)

Check whether the issuer (1) filed all reports required to be filed by section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirement for the past 90 days. Yes _X_ No ___

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

As of August 1, 2007, 72,310,703 shares of the issuer s common stock, $0.001 par value, were outstanding.

Transitional Small Business Disclosure Format (Check one): Yes ___ No X

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

PAYMENT DATA SYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS

	June 30, 2007 (Unaudited)	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 253,200	$ 198,759
Accounts receivable, net	95,231	89,021
Prepaid expenses and other	43,447	129,441
Total current assets	391,878	417,221
Property and equipment, net	142,644	157,616
Other assets	26,693	26,693
Total assets	$ 561,215	$ 601,530
Liabilities and stockholders equity (deficit)		
Current liabilities:		
Accounts payable	$ 145,022	$ 131,055
Accrued expenses	596,851	639,925
Note payable	-	359,280
Deferred revenue	22,377	36,434
Total current liabilities	764,250	1,166,694
Stockholders equity (deficit):		
Common stock, $0.001 par value, 200,000,000 shares authorized; 71,006,845 and 44,879,005 issued and outstanding	71,007	44,879
Additional paid-in capital	53,218,703	50,736,455

Deferred compensation		(1,780,366)		(588,775)
Accumulated deficit		(51,712,379)		(50,757,723)
Total stockholders equity (deficit)		(203,035)		(565,164)
Total liabilities and stockholders equity (deficit)	$	561,215	$	601,530

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,	
	2007	**2006**	**2007**	**2006**
Revenues	$ 761,935	$ 539,615	$ 1,395,131	$ 887,625
Operating expenses:				
Cost of services	608,007	404,956	1,132,122	703,338
Selling, general and administrative	473,981	433,611	1,016,136	877,441
Depreciation and amortization	19,609	20,891	37,186	42,358
Total operating expenses	1,101,597	859,458	2,185,444	1,623,137
Operating loss	(339,662)	(319,843)	(790,313)	(735,512)
Other income (expense):				
Interest income	220	54	568	243
Interest expense	(3,659)	(8,364)	(69,923)	(18,841)
Other income (expense)	-	-	(94,988)	-
Total other income (expense)	(3,439)	(8,310)	(164,343)	(18,598)
Loss from operations before income taxes	(343,101)	(328,153)	(954,656)	(754,110)
Income taxes	-	-	-	-
Net loss	$ (343,101)	$ (328,153)	$ (954,656)	$ (754,110)
Basic and diluted net loss per common share:	$ 0.00	$ (0.01)	$ (0.01)	$ (0.02)
Weighted average common shares outstanding	70,462,646	41,695,994	64,432,669	38,938,161

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six Months Ended June 30,	
	2007	**2006**
Operating activities:		
Net loss	$ (954,656)	$ (754,110)
Adjustments to reconcile net loss to net cash used in operating activities:		
Bad debts	-	15,000
Depreciation	37,186	42,358
Non-cash stock compensation	118,084	130,556
Deferred compensation	199,514	120,456
Amortization of debt discount	57,388	-
Changes in current assets and current liabilities:		
Accounts receivable	(6,210)	(87,990)
Prepaid expenses and other	85,994	(144,570)
Deferred revenue	(14,057)	4,555
Accounts payable and accrued expenses	(36,191)	65,542
Net cash used in operating activities	(512,948)	(608,203)
Investing activities:		
Deposits, net	-	10,000
Purchases of property and equipment	(22,214)	(43,467)
Net cash used in investing activities	(22,214)	(33,467)
Financing activities:		
Principal payments for notes payable	(416,668)	-
Issuance of common stock, net of issuance costs	1,006,271	376,484
Net cash provided by financing activities	589,603	376,484
Change in cash and cash equivalents	54,441	(265,186)
Cash and cash equivalents, beginning of period	198,759	378,098
Cash and cash equivalents, end of period	$ 253,200	$ 112,912

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1. Basis of Presentation

Payment Data Systems, Inc. and subsidiaries (the "Company"), has incurred substantial losses since inception, which has led to a significant decrease in its cash position and a deficit in working capital. The Company believes that its current available cash along with anticipated revenues may be insufficient to meet its anticipated cash needs for the foreseeable future. **Consequently, the Company s ability to continue as a going concern is likely contingent on the Company receiving additional funds in the form of equity or debt financing.** The Company is currently aggressively pursuing strategic alternatives (see Note 4). The sale of additional equity or convertible debt securities would result in additional dilution to the Company's stockholders, and debt financing, if available, may involve covenants which could restrict operations or finances. There can be no assurance that financing will be available in amounts or on terms acceptable to the Company, if at all. If the Company cannot raise funds on acceptable terms, or achieve positive cash flow, it may not be able to continue to exist, conduct operations, grow market share, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, any of which would negatively impact its business, operating results and financial condition. The accompanying unaudited consolidated financial statements of the Company do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

The accompanying unaudited consolidated financial statements of the Company have been prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal recurring nature considered necessary to present fairly the Company's financial position, results of operations and cash flows for such periods. The accompanying interim consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2006. 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.

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.

Note 2. Stock-Based Compensation

During the quarter ended March 31, 2007, the Company issued a total of 9,392,277 shares of common stock granted to employees on December 27, 2006 as a long-term incentive for which it recorded $845,305 of deferred compensation. The common stock is restricted and vests on December 27, 2016. The Company also issued a total of 120,000 shares granted to an independent contractor on December 27, 2006 as a long-term incentive for which it recorded $10,800 of deferred compensation. The common stock is restricted and vests equally over three years on the anniversary date of the grant.

On February 27, 2007, the Company executed employment agreements with Michael Long, Chief Executive Officer and Chief Financial Officer, and Louis Hoch, President and Chief Operating Officer, and subsequently issued 500,000 shares of common stock to each as a signing bonus under the terms of their respective employment agreements, for which the Company recorded $107,000 of expense. The Company also issued 2,500,000 shares of common stock to each as a long-term incentive under the terms of their respective employment agreements, for which the Company recorded $535,000 of deferred compensation. The incentive stock is restricted and vests annually over five years in increments of 500,000 shares beginning on February 28, 2009.

During the quarter ended June 30, 2007, the Company issued a total of 44,445 shares of common stock under the terms of its Comprehensive Employee Stock Plan to an independent contractor providing consulting services to the Company for which it recorded $4,000 of related expense.

Note 3. Note Payable

On August 21, 2006, the Company entered into a zero-discount promissory note with Dutchess Private Equities Fund, LP (Dutchess). Pursuant to the terms of the promissory note, the Company received $500,000 and promised to pay Dutchess $625,000 with a maturity date of August 21, 2007. In addition, the Company agreed to pay all financing proceeds raised during the term of the note exceeding the aggregate amount of $500,000 towards prepayment of the note. The balance of the note payable was $359,280 on December 31, 2006. On March 9, 2007, the Company received $500,000 in readily available funds from our sale of 5,000,000 shares of common stock on March 1, 2007, which brought the aggregate amount of financing raised during the term of the note to approximately $890,000. Accordingly, the Company prepaid the balance of the note in full on March 12, 2007 in the amount of $300,734.

Note 4. Equity Line of Credit

In February 2004, the Company executed an agreement for an equity line of credit with Dutchess. Under the terms of the agreement and at its election, the Company may receive as much as $10 million in common stock purchases by Dutchess through August 13, 2007. During the six months ended June 30, 2007, the Company sold 2,571,118 shares of its common stock pursuant to the equity line of credit and received total proceeds, net of issuance costs, of $238,736.

On June 11, 2007, the Company entered into an agreement for a new equity line of credit with Dutchess. Under the terms of the new 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 June 22, 2007 to register the resale of these shares (see Note 10). As of August 14, 2007, the SEC had not declared the registration statement effective.

Note 5. Issuance of Capital Stock

On January 18, 2007, the Company sold 3,000,000 shares of restricted common stock to Robert D. Evans, an individual investor, for a total offering price of $255,000 under a Stock Purchase Agreement. On March 1, 2007, the Company sold an additional 5,000,000 shares of restricted common stock to Robert D. Evans for a total offering price of $500,000 pursuant to a Stock Purchase Agreement.

Note 6. Income Taxes

The Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), on January 1, 2007. FIN 48 provides guidance for recognizing and measuring uncertain tax positions, as defined in Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. FIN 48 prescribes a threshold condition that a tax position must meet for any of the benefit of the uncertain tax position to be recognized in the financial statements. Guidance is also provided regarding de-recognition, classification and disclosure of these uncertain tax positions. Adoption of FIN 48 did not have a significant impact on the Company s financial statements.

At June 30, 2007, the Company had approximately $17,000,000 in unrecognized tax benefits (deferred tax assets for which a valuation allowance has been provided). The years ended December 31, 2002 through December 31, 2006 remain subject to examination by authorities. If applicable, the Company would recognize interest expense and penalties related to uncertain tax positions in interest expense. As of June 30, 2007, the Company had not accrued any interest related to uncertain tax provisions.

Note 7. Net Loss Per Share

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

Note 8. Related Party Transactions

Beginning in December 2000, the Company pledged as loan guarantees certain funds held as money market funds and certificates of deposit to collateralize margin loans for the following executive officers of the Company: (1) Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer; (2) Louis A. Hoch, then President and Chief Operating Officer; (3) Marshall N. Millard, then Secretary, Senior Vice President, and General Counsel; and (4) David S. Jones, then Executive Vice President. Mr. Millard and Mr. Jones are no longer employees of the Company. The margin loans were obtained in March 1999 from institutional lenders and were secured by shares of the Company's common stock owned by these officers. The pledged funds were held in the Company s name in accounts with the lenders that held the margin loans of the officers. The Company's purpose in collateralizing the margin loans was to prevent the sale of its common stock owned by these officers while it was pursuing efforts to raise additional capital through private equity placements. The sale of that common stock could have hindered the Company's ability to raise capital in such a manner and compromised its continuing efforts to secure additional financing. The highest total amount of funds pledged for the margin loans guaranteed by the Company was approximately $2.0 million. The total balance of the margin loans guaranteed by the Company was approximately $1.3 million at December 31, 2002. At the time the funds were pledged, the Company believed they would have access to them because (a) their stock price was substantial and the stock pledged by the officers, if liquidated, would produce funds in excess of the loans payable, and (b) with respect to one of the institutional lenders (who was also assisting the Company as a financial advisor at the time), even if the stock price fell, they had received assurances from that institutional lender that the pledged funds would be made available as needed. During the fourth quarter of 2002, the Company requested partial release of the funds for operating purposes, which request was denied by an institutional lender. At that time, their stock price had fallen as well, and it became clear that both institutional lenders would not release the pledged funds since the value of the stock pledged by the officers was less than the loans payable and the officers were unable to repay the loans. In light of these circumstances, the Company recognized a loss on the guarantees of $1,278,138 in the fourth quarter of 2002 and recorded a corresponding payable under related party guarantees on their balance sheet at December 31, 2002 because it became probable at that point that they would be unable to recover their pledged funds. During the quarter ended March 31, 2003, the lenders applied the pledged funds to satisfy the outstanding balances of the loans. The total balance of the margin loans guaranteed by the Company was zero at June 30, 2007. In February 2007, the Company signed employment agreements with Mr. Long and Mr. Hoch that require each to repay his respective obligation to the Company in four equal annual payments of cash or stock or any combination thereof. The Company may institute litigation or arbitration in collection of the outstanding repayment obligations of Mr. Millard and Mr. Jones, which currently total approximately $293,000. Presently, the Company has refrained from initiating action to recover funds from Mr. Millard because he may have an offsetting claim in excess of his repayment obligation by virtue of the deferred compensation clause in his employment agreement based on the Company s preliminary analysis. The Company has not pursued the outstanding repayment obligation of Mr. Jones because the Company does not consider a recovery attempt to be cost beneficial. In order to attempt a recovery from Mr. Jones, the Company estimates that it would incur a minimum of $20,000 in estimated legal costs with no reasonable assurance of success in recovering his outstanding obligation of approximately $38,000. Because of the limited amount of the obligation, the Company also anticipates difficulty in retaining counsel on a contingency basis to pursue collection of this obligation. The ultimate outcome of this matter cannot presently be determined.

Note 9. Shareholder Rights Plan

On February 28, 2007, the Company s Board of Directors amended the terms of the Common Stock Rights Agreement between the Company and American Stock Transfer & Trust Company, as Rights Agent. The Company amended the definition of an Acquiring Person in the Rights Agreement to mean any Person who or which shall be the Beneficial Owner of 20% or more of the shares of Common Stock then outstanding and amended the definition of Purchase Price in the Rights Agreement to be $0.10 for each share of Common Stock issued pursuant to the exercise of a Right.

Note 10. Subsequent Events

Subsequent to June 30, 2007 and through August 1, 2007, the Company sold 1,237,191 shares of its common stock pursuant to the equity line of credit (see Note 4) and received total proceeds, net of issuance costs, of $106,402.

On August 7, 2007, the Company filed an amended registration statement on Form SB-2 with the SEC to register the resale of the shares to be issued under the equity line of credit with Dutchess. As of August 14, 2007, the registration statement has not yet been declared effective by the SEC.

Item 2.

MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

FORWARD-LOOKING STATEMENTS DISCLAIMER

Except for the historical information contained herein, the matters discussed in this Form 10-QSB include certain forward-looking statements that involve risks and uncertainties, which are intended to be covered by safe harbors. Those statements include, but are not limited to, all statements regarding our and management s intent, belief and expectations, such as statements concerning our future and our operating and growth strategy. We generally use words such as "believe," "may," "could," "will," "intend," "expect," "anticipate," "plan," and similar expressions to identify forward-looking statements. 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 our ability to implement our business plan, our ability to raise additional funds and manage our substantial debts, consumer acceptance of our products, our ability to broaden our customer base, our ability to maintain a satisfactory relationship with our suppliers and other risks described in our reports filed 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, and our future results, levels of activity, performance or achievements may not meet these expectations. Investors are cautioned that all forward-looking statements involve risks and uncertainties including, without limitation, the factors set forth under the Risk Factors section of Item 6, Management s Discussion and Analysis of Financial Condition and Results of Operations, of the Annual Report on Form 10-KSB for the year ended December 31, 2006 and other factors detailed from time to time in our filings with the Securities and Exchange Commission. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved. All forward-looking statements made in this Form 10-QSB are based on information presently available to our management. We do not intend to update any of the forward-looking statements after the date of this document 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-KSB for the year ended December 31, 2006.

Overview

We provide integrated electronic payment processing services to merchants and businesses, including credit and debit card-based processing services and transaction processing via the Automated Clearinghouse Network. We also operate an online payment processing service for consumers under the domain name www.billx.com through which consumers can pay anyone. Since inception, we have incurred operating losses each quarter, and as of June 30, 2007, we have an accumulated deficit of $51.7 million. **Our prospects to continue as a going concern must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of growth, particularly companies in rapidly evolving markets such as electronic commerce.** Such risks include, but are not limited to, an evolving and unpredictable business model and our ability to continue as a going concern. To address these risks we must, among other things, grow and maintain our customer base, implement a successful marketing strategy, continue to maintain and upgrade our technology and transaction-processing systems, provide superior customer service, respond to competitive developments, attract, retain and motivate qualified personnel, and respond to unforeseen industry developments and other factors. We cannot assure you that we will be successful in addressing such risks, and the failure to do so could have a material adverse effect on our business, prospects, financial condition and results of operations. We believe that our success will depend in large part on our ability to (a) manage our operating expenses, (b) add quality customers to our client base, (c) meet evolving customer requirements and (d) adapt to technological changes in an emerging market. Accordingly, we intend to focus on customer acquisition activities and outsource some of our processing services to third parties to allow us to maintain an efficient operating infrastructure and expand our operations without significantly increasing our fixed operating expenses.

Critical Accounting Policies

General

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

Revenue Recognition

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

Reserve for Losses on Card Processing

If, due to insolvency or bankruptcy of the merchant, or for another reason, we are not able to collect amounts from our card processing merchant customers that have been properly "charged back" by the cardholders, we must bear the credit risk for the full amount of the cardholder transaction. We may require cash deposits and other types of collateral from certain merchants to minimize any such risk. In addition, we utilize a number of systems and procedures to manage merchant risk. Card merchant processing loss reserves are primarily determined by performing a historical analysis of our chargeback loss experience and considering other factors that could affect that experience in the future, such as the types of card transactions processed and nature of the merchant relationship with their consumers. This reserve amount is subject to risk that actual losses may be greater than our estimates. At June 30, 2007, our card merchant processing loss reserve was $209,220. We have not incurred any 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. We charged bad debt expense of $26,059 and recorded bad debt write-offs of $278 against our allowance for doubtful accounts in 2006. At June 30, 2007, the balance of the allowance for doubtful accounts was approximately $38,000. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make contractual payments, additional allowances may be required. Our estimate for bad debt losses is likely to increase in the future as our volume of transactions processed increases.

Valuation of Long-Lived and Intangible Assets

We assess the impairment of long-lived and intangible assets at least annually, and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important, which could trigger an impairment review, include the following: significant underperformance relative to historical or projected future cash flows; significant changes in the manner of use of the assets or the strategy of the overall business; and significant negative industry trends. When management determines that the carrying value of long-lived and intangible assets may not be recoverable, impairment is measured as the excess of the assets carrying value over the estimated fair value. No impairment losses were recorded in 2006 or during the six months ended June 30, 2007.

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, 2007 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, 2006, we had available net operating loss carryforwards of approximately $38.5 million, which expire beginning in the year 2020.

Results of Operations

Our revenues are principally derived from providing integrated electronic payment services to merchants and businesses, including credit and debit card-based processing services and transaction processing via the Automated Clearinghouse Network. We also operate an online payment processing service for consumers under the domain name www.billx.com and sell this service as a private-label application to resellers. Revenues for the quarter ended June 30, 2007 increased 41% to $761,935 from $539,615 for the quarter ended June 30, 2006. Revenues for the six months ended June 30, 2007 increased 57% to $1,395,131 from $887,625 for the six months ended June 30, 2006. The increases from the prior year periods was primarily attributable to the increase in revenues generated from card-based processing services due to increased transaction volume. Revenues generated by our billx.com online payment service for the first quarter and six months of 2007 decreased from the prior year periods due to a decrease in the average number of consumers subscribing to the service and we expect this trend to continue unless our current plan to introduce and establish enhanced value by offering a prepaid MasterCard in conjunction with the service is successful in generating subscriber growth. The monthly average number of such consumers decreased to 976 in the first six months of 2007 from 1,441 in the first six months of 2006. We expect our total revenues to increase as we anticipate growth in the volume of card transactions and additional merchant customers.

Cost of services includes the cost of personnel dedicated to the creation and maintenance of connections to third party payment processors and fees paid to such third party providers for electronic payment processing services. Through our contractual relationships with our payment processors, we are able to process Automated Clearinghouse and debit or credit card transactions on behalf of our customers and their consumers. We pay volume-based fees for debit and credit transactions initiated through these processors, and pay fees for other transactions such as returns, notices of change to bank accounts and file transmission. Cost of services was $608,007 and $404,956 for the quarters ended June 30, 2007 and 2006, respectively, and $1,132,122 and $703,338 for the six months ended June 30, 2007 and 2006, respectively. The increase from the prior year periods was due primarily to the increase in fees related to processing the increased card-based transaction volume.

Selling, general and administrative expenses increased to $473,981 for the quarter ended June 30, 2007, from $433,611 for the first quarter of 2006. Selling, general and administrative expenses for the six months ended June 30, 2007 increased to $1,016,136 from $877,441 for the six months ended June 30, 2006. The increase from the prior year periods was principally due to $69,687 and $199,916 of non-cash expense incurred for the quarter and six months ended June 30, 2007, respectively, related to signing and annual bonuses under executive employment agreements executed in March 2007.

Depreciation and amortization decreased to $19,609 for the quarter ended June 30, 2007, as compared to $20,891 for the first quarter of 2006. Depreciation and amortization for the six months ended June 30, 2007 decreased to $37,186 from $42,358 for the six months ended June 30, 2006. These decreases from prior periods were primarily due to lower depreciation expense related to certain assets that became fully depreciated during 2006. We capitalized $22,214 of computer hardware and software purchased during the quarter ended June 30, 2007 and anticipate making additional capital expenditures of approximately $100,000 over the remaining six months of 2007.

Net other expense decreased to $3,439 for the quarter ended June 30, 2007, from $8,310 for the second quarter of 2006. The decrease from the prior year quarter was attributable to lower interest expense incurred in the quarter ended June 30, 2007 due to a lower volume of puts under our equity line of credit with Dutchess. Net other expense increased to $164,343 for the six months ended June 30, 2007 from $18,598 for the six months ended June 30, 2006. The increase from the prior year period was attributable to $152,376 of interest expense and financing costs related to our note payable to Dutchess that was repaid in March 2007.

Net loss increased to $343,101 for the quarter ended June 30, 2007 from $328,153 for the prior year quarter and increased to $954,656 for the six months ended June 30, 2007 from $754,110 for the prior year comparable period. Net loss increased from the prior year quarter as a result of the increase in selling, general and administrative expenses as discussed. Net loss increased from the prior year period as a result of the increase in net other expense and selling, general and administrative expenses as discussed.

Liquidity and Capital Resources

At June 30, 2007, we had $253,200 of cash and cash equivalents, compared to $198,759 of cash and cash equivalents at December 31, 2006. We have incurred substantial losses since inception and have a deficit in net working capital. We believe that our current available cash and cash equivalents along with anticipated revenues may be insufficient to meet our anticipated cash needs for the foreseeable future. **Consequently, our ability to continue as a going concern may be contingent on us receiving additional funds in the form of equity or debt financing.** We are currently aggressively pursuing strategic equity financing alternatives such as a private placement or equity line of credit.

In February 2004, we executed an agreement for an equity line of credit with Dutchess Private Equities Fund, LP. Under the terms of the agreement, at our option we could have elected to receive as much as $10 million from Dutchess in common stock purchases through August 13, 2007. Through June 30, 2007, we sold a total of 11,265,445 shares of our common stock pursuant to the equity line of credit and received total proceeds, net of issuance costs, of $1,628,210. Since February 2004, we have also received $1,620,000 from Dutchess pursuant to promissory notes and issued 1,692,000 shares of our common stock valued at $235,469 and made note repayments of $1,913,000 to Dutchess.

On June 11, 2007, we entered into an agreement for a new equity line of credit with Dutchess. Under the terms of the new agreement, at our election we may receive as much as $10 million in common stock purchases by Dutchess over a period of five years. We agreed to file with the Securities and Exchange Commission, and have declared effective before any funds may be received under the agreement, a registration statement registering the resale of the shares of our common stock to be issued to Dutchess. We filed a registration statement on Form SB-2 with the SEC on June 22, 2007 to register the resale of these share and filed an amended registration statement on August 7, 2007. As of August 14, 2007, the registration statement has not yet been declared effective by the SEC.

On January 18, 2007, we sold 3,000,000 shares of restricted common stock to Robert D. Evans, an individual investor, for a total offering price of $255,000 under a Stock Purchase Agreement. On March 1, 2007, we sold an additional 5,000,000 shares of restricted common stock to Robert D. Evans for a total offering price of $500,000 pursuant to a Stock Purchase Agreement.

On August 21, 2006, we entered into a zero-discount promissory note with Dutchess. Pursuant to terms of the promissory note, we received $500,000 and promised to pay Dutchess $625,000 with a maturity date of August 21, 2007. We also issued 1,042,000 shares of restricted common stock to Dutchess as an incentive for the investment and agreed to register the common stock issued pursuant to the promissory note on the next registration statement that we file. Dutchess waived its right to include these shares in the registration statement we filed on June 22, 2007. Under the terms of the note, we agreed to pay all financing proceeds raised during the term of the note exceeding the aggregate amount of $500,000 towards prepayment of the note. On March 9, 2007, we received $500,000 in readily available funds from a sale of 5,000,000 shares of common stock on March 1, 2007 in a private placement, which brought the aggregate amount of financing raised during the term of the note to approximately $890,000. Accordingly, we prepaid the balance of the note in full on March 12, 2007 in the amount of $300,734.

The satisfactory completion of additional sales of common stock to private investors or under our equity line of credit, borrowing funds, or growth of cash flow from operations is essential to provide sufficient cash flows to meet our current operating requirements. The sale of additional equity or convertible debt securities would result in additional dilution to our stockholders, and debt financing, if available, may involve restrictive covenants which could restrict operations or finances. There can be no assurance that financing will be available in amounts or on terms acceptable to us, if at all. If we cannot raise funds, on acceptable terms, or achieve positive cash flow, we may not be able to continue to exist, conduct operations, grow market share, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, any of which would negatively impact our business, operating results and financial condition.

Net cash used in operating activities was $512,948 and $608,203 for the six months ended June 30, 2007 and 2006, respectively. Net cash used in operating activities was primarily attributable to operating net losses generated by growth stage activities and overhead costs. We plan to focus on expending our resources prudently given our current state of liquidity.

Net cash used in investing activities was $22,214 and $33,467 for the six months ended June 30, 2007 and 2006, respectively, and primarily reflected capital expenditures for computer hardware and software. We anticipate making capital expenditures of approximately $100,000 during the remaining six months of 2007.

Net cash provided by financing activities of $589,603 for the six months ended June 30, 2007 resulted from receiving $1,006,271 in net proceeds from the issuance of common stock, including $755,000 from private placements, and making payments of $416,668 under our note payable. Net cash provided by financing activities of $376,484 for the six months ended June 30, 2006 represented the net proceeds from the issuance of common stock under our equity line of credit.

Off-balance Sheet Arrangements

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

Item 3.

CONTROLS AND PROCEDURES

As of the end of the period covered by this Quarterly Report on Form 10-QSB, an evaluation was performed under the supervision and with the participation of our management, including the individual serving as both our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and 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 disclosure controls and procedures include components of our internal control over financial reporting. Management's assessment of the effectiveness of our internal control over financial reporting is expressed at the level of reasonable assurance that the control system, no matter how well designed and operated, can provide only reasonable, but not absolute, assurance that the control system's objectives will be met.

There was no change in our internal controls, which are included within disclosure controls and procedures, during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls.

PART II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Beginning in December 2000, we pledged as loan guarantees certain funds held as money market funds and certificates of deposit to collateralize margin loans for the following executive officers: (1) Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer; (2) Louis A. Hoch, then President and Chief Operating Officer; (3) Marshall N. Millard, then Secretary, Senior Vice President, and General Counsel; and (4) David S. Jones, then Executive Vice President. Mr. Millard and Mr. Jones are no longer our employees. The margin loans were obtained in March 1999 from institutional lenders and were secured by shares of our common stock owned by these officers. The pledged funds were held in our name in accounts with the lenders that held the margin loans of the officers. Our purpose in collateralizing the margin loans was to prevent the sale of our common stock owned by these officers while we were pursuing efforts to raise additional capital through private equity placements. The sale of that common stock could have hindered our ability to raise capital in such a manner and compromised our continuing efforts to secure additional financing. The highest total amount of funds pledged for the margin loans guaranteed by us was approximately $2.0 million. The total balance of the margin loans guaranteed by us was approximately $1.3 million at December 31, 2002. At the time the funds were pledged, we believed we would have access to them because (a) our stock price was substantial and the stock pledged by the officers, if liquidated, would produce funds in excess of the loans payable, and (b) with respect to one of the institutional lenders (who was also assisting us as a financial advisor at the time), even if the stock price fell, we had received assurances from that institutional lender that the pledged funds would be made available as needed. During the fourth quarter of 2002, we requested partial release of the funds for operating purposes, which request was denied by an institutional lender. At that time, our stock price had fallen as well, and it became clear that both institutional lenders would not release the pledged funds since the value of the stock pledged by the officers was less than the loans payable and the officers were unable to repay the loans. In light of these circumstances, we recognized a loss on the guarantees of $1,278,138 in the fourth quarter of 2002 and recorded a corresponding payable under related party guarantees on our balance sheet at December 31, 2002 because it became probable at that point that we would be unable to recover our pledged funds. During the quarter ended March 31, 2003, the lenders applied the pledged funds to satisfy the outstanding balances of the loans. The total balance of the margin loans guaranteed by us was zero at June 30, 2007. In February 2007, we signed employment agreements with Mr. Long and Mr. Hoch that require each to repay his respective obligation to us in four equal annual payments of cash or stock or any combination thereof. We may institute litigation or arbitration in collection of the outstanding repayment obligations of Mr. Millard and Mr. Jones, which currently total approximately $293,000. Presently, we have refrained from initiating action to recover funds from Mr. Millard because he may have an offsetting claim in excess of his repayment obligation by virtue of the deferred compensation clause in his employment agreement based on our preliminary analysis. We have not pursued the outstanding repayment obligation of Mr. Jones because we do not consider a recovery attempt to be cost beneficial. In order to attempt a recovery from Mr. Jones, we estimate that we would incur a minimum of $20,000 in estimated legal costs with no reasonable assurance of success in recovering his outstanding obligation of approximately $38,000. Because of the limited amount of the obligation, we also anticipate difficulty in retaining counsel on a contingency basis to pursue collection of this obligation. The ultimate outcome of this matter cannot presently be determined.

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

During the quarter ended June 30, 2007, we sold 786,418 shares of our common stock to Dutchess Private Equities Fund, Ltd. pursuant to an equity line of credit and received total proceeds, net of issuance costs, of $69,463.

The shares were sold in accordance with Rule 506 of Regulation D under the Securities Act of 1933 (as amended) in that:

- the sales were made to sophisticated or accredited investors, as defined in Rule 502;
- we gave each purchaser the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information which we possessed or could acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished;

•

at a reasonable time prior to the sale of securities, we advised each purchaser of the limitations on resale in the manner contained in Rule 502(d)2;

•

neither we nor any person acting on our behalf sold the securities by any form of general solicitation or general advertising; and

•

we exercised reasonable care to assure that each purchaser of the securities is not an underwriter within the meaning of Section 2(11) of the Securities Act of 1933 in compliance with Rule 502(d).

Item 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable.

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

At the Annual Meeting of Stockholders held on May 17, 2007, the following matters were approved by stockholders as indicated:

1.

To elect director Michael R. Long to serve until the 2010 Annual Meeting of Stockholders.

For:	60,577,098
Withheld:	690,586

2.

To ratify the appointment of Akin, Doherty, Klein & Fuege, P.C., certified public accountants, as the independent auditors of the Company for the year ending December 31, 2007.

For:	60,907,027
Against:	325,097
Abstain:	35,558

The following directors continued their term of office subsequent to the Annual Meeting: Michael R. Long, Louis A. Hoch and Peter G. Kirby.

Item 5. OTHER INFORMATION

None.

Item 6. EXHIBITS

Exhibit

Number

Description

3.1

Amended and Restated Articles of Incorporation (included as exhibit 3.1 to the Form 10-KSB filed March 31, 2006, and incorporated herein by reference).

3.2

Amended and Restated By-laws (included as exhibit 3.2 to the Form 10-KSB filed March 31, 2006, and incorporated herein by reference).

4.1

Amended and Restated 1999 Employee Comprehensive Stock Plan (included as exhibit 10.1 to the Form 8-K filed January 3, 2006, and incorporated herein by reference).

4.2

Amended and Restated 1999 Non-Employee Director Plan (included as exhibit 10.2 to the Form 8-K filed January 3, 2006, and incorporated herein by reference).

4.3

Employee Stock Purchase Plan (included as exhibit 4.3 to the Form S-8 filed February 23, 2000, and incorporated herein by reference).

4.4

Registration Rights Agreement between the Company and Dutchess Private Equities Fund, LP, dated June 6, 2004 (included as exhibit 10.9 to the Form SB-2 filed June 18, 2004, and incorporated herein by reference).

4.5

Rights Agreement between the Company and American Stock Transfer & Trust Company, dated February 28, 2007 (included as exhibit 4.1 to the Form 8-K filed March 5, 2007, and incorporated herein by reference).

10.1

Lease Agreement between the Company and Frost National Bank, Trustee for a Designated Trust, dated August 2003 (included as exhibit 10.3 to the Form 10-Q filed November 14, 2003, and incorporated herein by reference).

10.2

Employment Agreement between the Company and Michael R. Long, dated February 27, 2007 (included as exhibit 10.1 to the Form 8-K filed March 2, 2007, and incorporated herein by reference).

10.3

Employment Agreement between the Company and Louis A. Hoch, dated February 27, 2007 (included as exhibit 10.2 to the Form 8-K filed March 2, 2007, and incorporated herein by reference).

10.4

Investment Agreement between the Company and Dutchess Private Equities Fund, LP, dated June 4, 2004 (included as exhibit 10.8 to the Form SB-2 filed June 18, 2004, and incorporated herein by reference).

10.5

Placement Agent Agreement between the Company, Charleston Capital Corporation, and Dutchess Private Equities Fund, LP, dated June 4, 2004 (included as exhibit 10.10 to the Form SB-2 filed June 18, 2004, and incorporated herein by reference).

10.6

Affiliate Office Agreement between the Company and Network 1 Financial, Inc. (included as exhibit 10.11 to the Form SB-2 filed April 28, 2004, and incorporated herein by reference).

10.7

Warrant Agreement between the Company and Kubra Data Transfer LTD, dated as of September 30, 2004 (included as exhibit 10.1 to the Form 8-K filed October 6, 2004, and incorporated herein by reference).

10.8

Promissory Note between the Company and Dutchess Private Equities Fund, II, LP, dated August 21, 2006 (included as exhibit 10.1 to the Form 8-K filed August 25, 2006, and incorporated herein by reference).

10.9

Investment Agreement between the Company and Dutchess Private Equities Fund, Ltd., dated June 11, 2007 (included as exhibit 10.1 to the Form 8-K filed June 15, 2007, and incorporated herein by reference).

10.10

Registration Rights Agreement between the Company and Dutchess Private Equities Fund, Ltd., dated June 11, 2007 (included as exhibit 10.2 to the Form 8-K filed June 15, 2007, 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.

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.

SIGNATURE

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: August 14, 2007

Payment Data Systems, Inc.

By: /s/ Michael R. Long
Michael R. Long
Chairman of the Board, Chief Executive Officer and Chief Financial Officer
(principal executive officer and principal financial and accounting officer)