PAYMENT DATA SYSTEMS INC
Form 10-Q
November 14, 2003

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

FORM 10-Q

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

For the quarterly period ended September 30, 2003

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 0-30152

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

Nevada	98-0190072
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification number)

12500 San Pedro, Suite 120
San Antonio, Texas 78216
(Address of principal executive offices)

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

211 North Loop 1604 East, Suite 200
San Antonio, Texas 78232
(Former address of principal executive offices, changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by section 13 or 15(d) of 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 requirement for the past 90 days. Yes X No ___

At November 1, 2003, 20,722,656 shares of the registrant's common stock, $.001 par value, were outstanding.

PAYMENT DATA SYSTEMS, Inc.

(FORMERLY BILLSERV, INC.)

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PART I - FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

PAYMENT DATA SYSTEMS, INC.
(FORMERLY BILLSERV, INC.)
CONSOLIDATED BALANCE SHEETS

	September 30, 2003 (Unaudited)	Decem
Assets:		
Current assets:		
Cash and cash equivalents	$ 613,655	$
Cash pledged as collateral for related party obligations	-	
Accounts receivable, net	323,234	
Prepaid expenses and other	213,819	
Total current assets	1,150,708	
Property and equipment, net	262,456	
Intangible asset, net	11,250	
Other assets	30,282	
Net property and equipment of discontinued operations	-	
Total assets	$ 1,454,696	$
Liabilities and stockholders' equity (deficit):		
Current liabilities:		
Accounts payable	$ 620,645	$
Accrued expenses and other current liabilities	250,863	
Payable under related party guarantees	-	
Short-term borrowings	-	
Deferred revenue	-	
Obligations under capital leases of discontinued operations	-	
Total current liabilities	871,508	
Stockholders' equity (deficit):		
Common stock, $.001 par value, 200,000,000 shares authorized; 20,722,656 issued and outstanding at September 30, 2003, 20,603,799 issued and outstanding at December 31, 2002	20,723	
Additional paid-in capital	46,793,027	
Accumulated deficit	(46,230,562)	(
Total stockholders' equity (deficit)	583,188	
Total liabilities and stockholders' equity (deficit)	$ 1,454,696	$

See notes to interim consolidated financial statements.

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PAYMENT DATA SYSTEMS, INC.
(FORMERLY BILLSERV, INC.)
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended		Nine Months
	September 30, 2003	September 30, 2002	September 30, 2003
Revenues	$ 29,342	$ 20,774	$ 82,413
Cost of revenues	59,022	15,060	96,286
Gross margin	(29,680)	5,714	(13,873)
Operating expenses:			
Selling, general and administrative	455,784	646,594	1,281,035
Depreciation and amortization	29,827	47,215	98,461
Total operating expenses	485,611	693,809	1,379,496
Operating loss	(515,291)	(688,095)	(1,393,369)
Other income (expense), net:			
Interest income	299	13,457	4,493
Interest expense	(643)	(454,096)	(61,423)
Other income (expense)	179,474	(17,981)	160,317
Total other income, net	179,130	(458,620)	103,387
Loss from continuing operations before income taxes	(336,161)	(1,146,715)	(1,289,982)
Income taxes	-	-	-
Loss from continuing operations	(336,161)	(1,146,715)	(1,289,982)
Discontinued operations (Note 5):			
Income (loss) from discontinued operations, net of no income taxes	188,319	(1,128,990)	(572,780)
Gain on disposition of discontinued operations, net of no income taxes	2,768,260	-	2,768,260
Net income (loss)	$ 2,620,418	$ (2,275,705)	$ 905,498
Loss from continuing operations per common share - basic and diluted	$ (0.01)	$ (0.06)	$ (0.06)
Income (loss) from discontinued operations per common share - basic and diluted	$ 0.14	$ (0.05)	$ 0.10
Net income (loss) per common share - basic and diluted	$ 0.13	$ (0.11)	$ 0.04
Weighted average common shares outstanding - basic and diluted	20,722,656	20,602,074	20,710,634

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.
(FORMERLY BILLSERV, INC.)
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
Cash flows from operating activities:		
Loss from continuing operations	$ (1,289,982)	$ (2,479,166)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities:		
Depreciation and amortization	98,461	133,460
Issuance of common stock warrants and convertible debt	-	425,509
Changes in current assets and current liabilities:		
(Increase) decrease in accounts receivable	335,840	(264,342)
Decrease in related party notes receivables	-	162,154
(Increase) decrease in prepaid expenses and other	43,991	(142,123)
Increase (decrease) in accounts payable, accrued expenses and other current liabilities	(617,194)	245,886
Decrease in deferred revenue	(400,960)	(182,256)
Net cash used in continuing operations	(1,829,844)	(2,100,878)
Net cash used in discontinued operations	(251,972)	(3,465,943)
Net cash used in operating activities	(2,081,816)	(5,566,821)
Cash flows from investing activities:		
Purchases of property and equipment	(25,016)	(9,522)
Long-term deposits, net	(30,282)	188,603
Proceeds from sale of equipment	4,224,108	-
Other investing activities	-	(6,126)
Net cash provided by investing activities	4,168,810	172,955
Cash flows from financing activities:		
Cash pledged as collateral for related party obligations	1,311,984	662,155
Payments for related party obligations	(1,278,138)	-
Proceeds from notes payable	-	2,145,000
Principal payments for notes payable	(1,800,000)	(645,000)
Principal payments for capital lease obligations	-	(136,784)
Financing costs, net	-	(207,703)
Issuance of common stock, net of issuance costs	6,710	63,235
Net cash provided by (used in) financing activities	(1,759,444)	1,880,903
Net increase (decrease) in cash and cash equivalents	327,550	(3,512,963)
Cash and cash equivalents, beginning of period	286,105	4,173,599

Cash and cash equivalents, end of period	$ 613,655	$ 660,636

See notes to interim consolidated financial statements.

PAYMENT DATA SYSTEMS, INC.
(FORMERLY bILLSERV, INC.)
Notes to INTERIM Consolidated Financial Statements
(UNAUDITED)

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Payment Data Systems, Inc. ("PDS" or the "Company"), formally known as Billserv, Inc., have been prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal recurring nature considered necessary to present fairly the Company's financial position, results of operations and cash flows for such periods. The accompanying interim consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002. Results of operations for interim periods are not necessarily indicative of results that may be expected for any other interim periods or the full fiscal year. Certain prior period amounts have been reclassified to conform to the current year presentation. In prior fiscal years, the Company had been in the development stage, but is no longer considered to be a development stage company.

The consolidated balance sheet at December 31, 2002 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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

The Company applies the intrinsic value method under the recognition and measurement provisions of APB No. 25, "Accounting for Stock Issued to Employees", in accounting for its stock option and stock purchase plans. Accordingly, no stock-based employee compensation expense has been recognized for options granted with an exercise price equal to the market value of the underlying common stock on the date of grant or in connection with the employee stock purchase plan. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB No. 123, "Accounting for Stock-Based Compensation" ("FAS 123"), to stock-based employee compensation.

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	Three Months Ended September 30, 2003	Three Months Ended September 30, 2002	Nine Months Ended S 2003	
Net income (loss), as reported	$ 2,620,418	$ (2,275,705)	$ 905,498	$
Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(206,278)	(289,887)	(572,608)	
Pro forma net income (loss)	2,414,140	(2,565,592)	332,980	
Net income (loss) per common share - basic and diluted, as reported	$ 0.13	$ (0.11)	$ 0.04	$
Net income (loss) per common share - basic and diluted, pro forma	$ 0.12	$ (0.12)	$ 0.02	$

The effects of applying FAS 123 in this pro forma disclosure are not indicative of future amounts. Additional awards in future years are anticipated.

Note 3. Related Party Transactions

As of December 31, 2002, the Company had pledged $1.3 million to collateralize certain margin loans of three officers and an ex-officer of the Company. The margin loans are from institutional lenders and are secured by shares of the Company's common stock held by these individuals. The pledged funds were classified as Cash pledged as collateral for related party obligations on the Company's balance sheet at December 31, 2002. During the fourth quarter of 2002, the Company recognized a loss of $1,278,000 and recorded a corresponding payable related to the probable loss. During the quarter ended March 31, 2003, the institutional lenders applied $1,278,000 of the pledged funds being held to satisfy the outstanding balances of the loans and released the remaining $34,000 for return to the Company. The total balance of the margin loans guaranteed by the Company was zero at September 30, 2003. The Company may institute litigation or arbitration concerning these matters, which may result in the assertion of claims by these officers under their employee agreements. The ultimate outcome of this matter cannot presently be determined.

Note 4. Going Concern

The Company has incurred substantial losses since inception and has experienced a material shortfall from anticipated revenues, which has led to a significant decrease in its cash position and a deficit in working capital. Also, the Company defaulted under its convertible debt agreement during the fourth quarter of 2002 and was unsuccessful in its attempt to access its funds held as collateral to guarantee certain executive margin loans (see Note 3) after attempting to retrieve such funds during the fourth quarter of 2002. Consequently, 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. Accordingly, the Company reduced expenditures for operating requirements, including a reduction of 36 employees in its workforce in November 2002, and sold substantially all of its assets on July 25, 2003 (see Note 5). The satisfactory completion of an additional investment in the Company may be essential to provide sufficient cash flows to meet future operating requirements. 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 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 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.

Note 5. Discontinued Operations - Asset Sale

On July 25, 2003 (the "Closing") the Company sold substantially all of its assets (the "Business") to Saro, Inc., a Delaware corporation (the "Purchaser"), which is a wholly owned subsidiary of CyberStarts, Inc., a Delaware corporation (the "Sale"). The aggregate selling price for the Business was $4,800,000 (the "Purchase Price"), including $700,000 subject to certain earnout provisions, plus the Purchaser's assumption of certain liabilities of the Company. The Purchase Price was determined through extensive negotiations between the Purchaser and the Company. The board of directors of the Company, in its reasonable business judgment, approved the Purchase Price based upon the following factors: 1) the extensive search for a purchaser of the Business; 2) the number of offers made by potential purchasers for the Business; 3) the Company's ability to raise other sources of capital to operate the Business; and 4) the future trends in the industry of the Business. The sale of the Business was approved by a majority of the shareholders of PDS at a Special Meeting of Shareholders held on July 14, 2003. The assets sold represent the Company's proprietary technology infrastructure along with certain third party software and hardware platforms and certain furniture and fixtures that support its service offerings, including its eServ and eConsulting products. The carrying value of these non-current assets was approximately $1,068,000 at July 25, 2003. The Purchaser also assumed certain current and non-current liabilities with carrying values of $83,000 and $30,000, respectively, at July 25, 2003. The assets sold represent virtually all of the Company's assets, which it uses to produce nearly all of its revenue; therefore, the Company has ceased its primary operations and will continue to operate its bills.com consumer bill payment portal and concentrate on building its electronic payments business. The results of operations for the asset group disposed of have been reported as discontinued operations in the accompanying statements of operations. During the quarters ended September 30, 2003 and 2002, these discontinued operations provided revenue of $357,000 and $807,000, respectively. During the nine months ended September 30, 2003 and 2002, these discontinued operations provided revenue of $2,155,000 and $3,245,000, respectively. The Company retained its accounts receivable and related deferred revenue associated with the customers of the Business, as well as certain accounts payable and accrued liabilities related to the Business that the Company is responsible for but which it does not expect to incur similar costs in the future. At September 30, 2003, the Company's balance sheet included approximately $321,000 of net accounts receivable and approximately $574,000 of current liabilities that related to the operations of the Business.

At Closing, the Purchaser paid the Company $4,100,000 in cash. The Company may earn an additional $700,000 based upon two earnouts calculated upon gross revenues of the Business for the four consecutive quarters following the Closing, the first quarter of which begins the first day of the first full month after the Closing. The Sale of the Business qualifies as a change of control under the employee agreements of certain officers of the Company, which may result in the assertion of claims by these officers under their employee agreements. The ultimate outcome of this matter cannot presently be determined. Subsequent to the Sale, the Company settled claims made under employee agreements by the Chief Financial Officer and Chief Marketing Officer for cash consideration of $200,000 in the aggregate, including approximately $30,000 that is contingent on the Company meeting the earnout provisions of the Sale, and terminated their respective employee agreements.

Note 6. Market Information

On July 29, 2003, the Company amended its articles of incorporation to change its name to Payment Data Systems, Inc. The Company began trading on the Nasdaq OTC market under a new symbol, PYDS, on August 20, 2003.

Note 7. Facilities Lease

In March 2003, the Company's amended five-year operating lease for its corporate headquarters was terminated by the lessor for nonpayment of rent. Subsequently, the lessor executed a monthly lease with no renewal option for approximately 25,000 square feet with the Company. In August 2003, the Company signed a three-year lease for approximately 4,500 square feet that will serve as the Company's headquarters.

Note 8. Stockholders' Equity

During the nine months ended September 30, 2003, the Company issued 43,857 shares of common stock pursuant to its Employee Stock Purchase Plan at a price of $0.15 per share.

During the nine months ended September 30, 2003, the Company issued 75,000 shares of common stock to certain independent contractors performing services for the Company. Such shares were issued pursuant to Section 506 of Regulation D of the Securities and Exchange Act of 1933 as an issuance of unregistered securities to a sophisticated investor. The Company recorded $16,250 of expense related to the issuance of this stock.

Note 9. Legal Proceedings

On July 25, 2003, certain stockholders of the Company (such stockholders being Mike Procacci, Jr., Mark and Stefanie McMahon, Anthony and Lois Tedeschi, Donna and James Knoll, John E. Hamilton, III, William T. Hagan, Samuel A. Fruscione, Dana Fruscione-Penzone, Gia Fruscione, Alicia Fruscione, Joseph Fruscione, Robert Evans, John Arangio, Gary and JoAnne Gardner, Lee and Margaret Getson, G. Harry Bonham, Jr., Gary Brewer, Bob Lastowski, Robert Filipe, Mitchell D. Hovendick, Dr. John Diephold, Joseph Maressa, Jr., and Charles Brennan (collectively, the "Plaintiffs")) commenced legal action against the Company, Ernst & Young, LLP and certain of the Company's former directors (such directors being Louis A. Hoch, Michael R. Long, David S. Jones, Roger Hemminghaus, E. Scott Crist, Peter Kirby, Richard Bergman, and Terri A. Hunter (the "Defendant Directors")) in the District Court of the 45th Judicial District, Bexar County, Texas (the "Suit"). The Plaintiffs allege, as the Suit pertains to the Company, that the Company, acting through the Defendant Directors, misstated in the Company's 2000 and 2001 Form 10-Ks the Company's ability to use for operational purposes certain Company funds pledged as security for margin loans of three Company officers. The Plaintiffs seek economic and exemplary damages, rescission, interest, attorneys' fees, and costs of court.

The Company believes the Suit to be without merit, and intends to vigorously defend itself and the Defendant Directors.

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

The following discussion and analysis of financial condition and results of operations contains forward-looking statements that involve a number of risks and uncertainties. Actual results in future periods may differ materially from those expressed or implied in such forward-looking statements. This discussion should be read in conjunction with the unaudited interim consolidated financial statements and the notes thereto included in this report, and the Company's Annual Report on Form 10-K for the year ended December 31, 2002. All references to "we," "us" or "our" in this Form 10-Q mean Payment Data Systems, Inc. ("PDS" or the "Company").

Overview

On July 25, 2003 (the "Closing") the Company sold substantially all of its assets (the "Business") to Saro, Inc., a Delaware corporation (the "Purchaser"), which is a wholly owned subsidiary of CyberStarts, Inc., a Delaware corporation (the "Sale"). The aggregate selling price for the Business was $4,800,000 (the "Purchase Price"), including $700,000 subject to certain earnout provisions, plus the Purchaser's assumption of certain liabilities of the Company. The Purchase Price was determined through extensive negotiations between the Purchaser and the Company. The board of directors of the Company, in its reasonable business judgment, approved the Purchase Price based upon the following factors: 1) the extensive search for a purchaser of the Business; 2) the number of offers made by potential purchasers for the Business; 3) the Company's ability to raise other sources of capital to operate the Business; and 4) the future trends in the industry of the Business. The sale of the Business was approved by a majority of the shareholders of PDS at a Special Meeting of Shareholders held on July 14, 2003. The assets sold represent the Company's proprietary technology infrastructure along with certain third party software and hardware platforms and certain furniture and fixtures that support its service offerings, including its eServ and eConsulting products. The carrying value of these non-current assets was approximately $1,068,000 at July 25, 2003. The Purchaser also assumed certain current and non-current liabilities with carrying values of $83,000 and $30,000, respectively, at July 25, 2003. The assets sold represent virtually all of the Company's assets, which it uses to produce nearly all of its revenue; therefore, the Company has ceased its primary operations and will continue to operate its bills.com consumer bill payment portal and concentrate on building its electronic payments business. The results of operations for the asset group disposed of have been reported as discontinued operations in the accompanying statements of operations. During the quarters ended September 30, 2003 and 2002, these discontinued operations provided revenue of $357,000 and $807,000, respectively. During the nine months ended September 30, 2003 and 2002, these discontinued operations provided revenue of $2,155,000 and $3,245,000, respectively.The Company retained its accounts receivable and related deferred revenue associated with the customers of the Business, as well as certain accounts payable and accrued liabilities related to the Business that the Company is responsible for but which it does not expect to incur similar costs in the future. At September 30, 2003, the Company's balance sheet included approximately $321,000 of net accounts receivable and approximately $574,000 of current liabilities that related to the operations of the Business.

Prior to the Sale, PDS provided electronic bill presentment and payment ("EBPP") and related services to companies that generate recurring bills, primarily in the United States. EBPP is the process of sending bills to consumers securely through the Internet and processing Internet payment of bills utilizing an electronic transfer of funds. Our service offering allowed companies to outsource their electronic billing process, providing them a single point of contact for developing, implementing and managing their EBPP process. PDS offered services to consolidate customer billing information and then securely deliver an electronic bill to the biller's own payment Web site hosted by PDS, the consumer's e-mail inbox and numerous Internet bill consolidation Web sites, such as those sponsored by financial institutions. Our EBPP services allowed billers to establish an interactive, online relationship with their consumers by integrating Internet customer care and direct marketing with the electronic bill. PDS also provided Internet-based customer care interaction services and professional services to assist with the implementation and maintenance of an electronic bill offering. As a condition of the Sale to Saro, Inc., PDS and certain principal employees of PDS agreed, for a period of two years, not to compete in the business of providing electronic bill presentment services in conjunction with bill payment solutions (the "Restricted Business"). Under such non-compete provisions, PDS and the applicable officers are prohibited from performing the Restricted Business 1) for

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former Restricted Business customers of PDS; or 2) in geographic areas in which PDS performed the Restricted Business prior to the Sale. The Company continues to operate an Internet electronic payment processing service for consumers under the domain name www.bills.com and provides integrated electronic payment services, including credit and debit card-based processing services and transaction processing via the ACH network.

Since inception, we have incurred operating losses each quarter, and as of September 30, 2003, we have an accumulated deficit of $46.2 million. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of growth, particularly companies in new and 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.

As a result of our limited operating history and the emerging nature of the markets in which we compete, we are unable to precisely forecast our revenues. Our current and future expense levels are based largely on our investment plans and estimates of future revenues. Revenue and operating results will depend on the volume of payment transactions processed and related services rendered. The timing of such services and transactions and our ability to fulfill a customer's demands are difficult to forecast. Although we systematically budget for planned outlays and maintain tight controls on our expenditures, we may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. Accordingly, any significant shortfall in revenues in relation to our planned expenditures could have a material adverse effect on our business, prospects, financial condition and results of operations. Further, we may make certain pricing, service, marketing or acquisition decisions that could have a material adverse effect on each or all of these areas.

Critical Accounting Policies

General

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company 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, the Company evaluates its estimates, including those related to the reported amounts of revenues and expenses, bad debt, investments, intangible assets, income taxes, and contingencies and litigation. The Company bases its 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.

Revenue Recognition

Prior to December 31, 1999, the Company recognized revenue generated from up-front fees upon completion of an implementation project. These up-front fees are charged for the work involved in implementing the basic functionality required to provide EBPP services to customers. These set-up procedures include tasks such as

establishing connectivity, design and construction of the hosted Web site, and conversion of the paper bill print stream to an electronic format. In December 1999, the SEC issued SAB 101, which requires that revenue generated from up-front implementation fees that do not represent a separate earnings process to be recognized over the term of the related service contract. The Company adopted SAB 101 on January 1, 2000, and accordingly, revised our implementation fee revenue recognition policy to defer this type of revenue, while the related costs will be expensed as incurred. The cumulative effect of this accounting change totaled $52,273 and was recognized as a non-cash after-tax charge during the first quarter of 2000. The cumulative effect was recorded as deferred revenue to be recognized as revenue over the remaining contractual service periods, which were primarily three to five years in length. At December 31, 2002, deferred revenue was $400,960. As of September 30, 2003, there was no balance of deferred revenue due to the recognition of all remaining deferred revenue in conjunction with the sale of the Business.

Bad Debt

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability or failure of its customers to make required payments. There were no write-offs or bad debt expense recorded to the allowance for doubtful accounts for the nine months ended September 30, 2003. At September 30, 2003 and December 31, 2002, the balance of the allowance for doubtful accounts was $47,197. If the financial condition of these customers were to deteriorate, resulting in an impairment of their ability to make contractual payments, additional allowances may be required.

Valuation of Long-Lived and Intangible Assets

The Company assesses the impairment of long-lived and intangible assets 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. An impairment loss of $200,000 was recorded in the quarter ended June 30, 2003 and an impairment loss of $855,000 was recorded in the quarter ended December 31, 2002.

Income Taxes

The Company accounts for income taxes using the liability method in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("FAS 109"). The liability method provides that the 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 carried on the balance sheet 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 tax assets carried on our balance sheet as of September 30, 2003 will be fully realized in future periods. FAS 109 requires a valuation allowance to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. After consideration of all of the evidence, both positive and negative, management determined that a valuation allowance at December 31, 2002 is necessary to reduce the deferred tax assets to the amount that will more likely than not be realized. The change in valuation allowance for 2002 is a net increase of $3.7 million. At December 31, 2002, the Company has available net operating loss carryforwards of approximately $34.8 million, which expire beginning in the year 2020.

Results of Continuing Operations

Subsequent to the Sale, our only continuing revenues were derived from the operation of an Internet electronic payment processing service for consumers under the domain name www.bills.com. The Company also provides integrated electronic payment services to businesses, including credit and debit card-based processing services as an Independent Sales Organization (ISO) and transaction processing via the ACH network. We processed our first ACH transactions during the quarter ended September 30, 2003, but the only component of our service offering that generated significant revenue for this quarter was the bills.com payment service. Total revenues for the quarter ended September 30, 2003 increased 41% to $29,342 from $20,774 for the quarter ended September 30, 2002. Total revenues for the nine months ended September 30, 2003 increased 52% to $82,413 from $54,267 for the nine months ended September 30, 2002. The increases from the prior year periods were primarily attributable to an increase in the number of consumers subscribing to the bills.com payment service. We anticipate generating revenue from the processing of credit card transactions under an existing electronic payment services contract during the fourth quarter of 2003.

Cost of revenues 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. Cost of revenues was $59,022 and $15,060 for the quarters ended September 30, 2003 and 2002, respectively, and $96,286 and $42,393 for the nine months ended September 30, 2003 and 2002, respectively. The increases from the prior year periods are due to the higher subscriber volume of the bills.com payment service and implementation fees charged in the third quarter of 2003 by third-party payment processors to initiate electronic payment processing services.

Selling, general and administrative expenses decreased to $455,784 and $1,281,035 for the quarter and nine months ended September 30, 2003, respectively, from $646,594 and $1,895,839 for the comparable periods of 2002, respectively. The decreases in such expenses from the prior year periods were primarily due to lower salary and benefit costs due to the personnel reductions during 2002.

Depreciation and amortization decreased to $29,827 and $98,461 for the quarter and nine months ended September 30, 2003, respectively, from $47,215 and $144,710 for the comparable periods of 2002, respectively. These decreases were due to lower depreciation related to certain assets that became fully depreciated during 2002. We purchased $25,000 of software during the quarter ended September 30, 2003 and anticipate making approximately $50,000 in capital expenditures over the remaining three months of 2003.

Net other income was $179,130 for the quarter ended September 30, 2003, compared to net other expense of $458,620 for the comparable quarter of 2002. Net other income was $103,387 for the nine months ended September 30, 2003, as compared to net other expense of $450,491 for the prior year period. These changes were primarily attributable to $445,000 of interest expense recognized in the third quarter of 2002 related to the Company's convertible debt and $165,000 of consulting fees recognized in other income in the third quarter of 2003 for transitional EBPP consulting services provided to the Company's former equal partner in an EBPP joint venture in Australia. The joint venture was dissolved as a result of the Company's sale of the Business during the third quarter of 2003. The changes from the prior year periods also reflect lower interest income earned in 2003 as a result of lower invested balances.

Loss from continuing operations improved to $336,161 and $1,146,715 for the quarter and nine months ended September 30, 2003, from $1,289,982 and $2,479,166 for the comparable periods of 2002, respectively, primarily as a result of the overall decrease in total operating expenses and interest expense from the prior year periods.

Results of Discontinued Operations

The following table presents the operating results of the Company's Business for the three and nine-month periods ended September 30, 2002 and 2003, which are reflected as discontinued operations in the Consolidated Statements of Operations.

	Three Months Ended		Nine Months
	September 30, 2003	September 30, 2002	September 30, 2003
Service revenues:			
Transaction revenues	$ 155,047	$ 484,903	$ 1,273,931
Implementation revenues	146,080	74,791	256,564
Consulting revenues	56,081	247,268	624,787
Total service revenues	357,208	806,962	2,155,282
Software license revenues	-	-	-
Total revenues	357,208	806,962	2,155,282

Cost of service revenues	53,743	1,087,387	1,436,449
Cost of software license revenues	-	-	-
Total cost of revenues	53,743	1,087,387	1,436,449
Gross margin	303,465	(280,425)	718,833
General and administrative	6,388	231,973	308,998
Selling and marketing	54,634	196,960	120,833
Research and development	10,615	114,044	82,555
Provision for impairment of assets	-	-	200,000
Depreciation and amortization	43,509	305,535	579,227
Equity in loss of unconsolidated subsidiary	-	53	-
Income (loss) from discontinued operations	$ 188,319	$ (1,128,990)	$ (572,780)

Prior to the Sale, our revenues were principally derived from fees for implementing EBPP capabilities, processing EBPP transactions and providing related customer care, and consulting services. PDS also became a licensed reseller of CheckFree's e-billing software in Australia during 2002. The components of our service offering that generated revenue through July 25, 2003, include:

- Internet billing services for EBPP through a PDS-hosted payment Web site, secure direct delivery to the consumer's email inbox, or distribution via bill aggregators.
- Internet-enabled, interactive customer care services on an in-house or outsourced basis.
- Professional consulting services for EBPP billers or software vendors needing value-added resources to deliver customized EBPP services, including payment gateway services that provide billers who are already participating in EBPP using in-house software a single distribution point to virtually any bill presentment and payment location across the World Wide Web in addition to their existing distribution points or biller direct site.
- Licensing of CheckFree e-billing software as an authorized reseller in Australia only.
- Online bill payment and management services for consumers through the bills.com Internet portal.

Total revenues for the quarter ended September 30, 2003 decreased 56% to $357,208 from $806,962 for the quarter ended September 30, 2002. Total revenues for the nine months ended September 30, 2003 decreased 34% to $2,155,282 from $3,245,554 for the nine months ended September 30, 2002. The decreases from the prior year periods were partially attributable to the Sale of the Business, which resulted in revenue generated by the Business being

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recognized only through July 25, 2003 for the third quarter of 2003. This decrease in revenues was partially offset by the increase in implementation fee revenue, due to the recognition of the remaining balance of deferred revenue upon the sale of the Business. The decrease from the prior year nine-month period was also attributable to a decrease in consulting revenues, which includes revenue from the licensing of the Company's gateway technology. The Company's lack of any software license sales in 2003 as a reseller of CheckFree's e-billing software in Australia also contributed to the decreases in total revenue from the prior year nine-month period.

Cost of revenues includes the cost of personnel dedicated to the design of electronic bill templates, creation of connections to third-party aggregators and payment processors, testing and quality assurance processes related to implementation and presentment, as well as professional staff dedicated to providing contracted services to EBPP customers under consulting arrangements. Cost of revenues also includes fees paid for presentation of consumer bills on Web sites powered by aggregators and processing of payments for EBPP transactions by third party providers. Cost of revenues was $53,743 and $1,087,387 for the quarters ended September 30, 2003 and 2002, respectively, and $1,436,449 and $3,717,210 for the nine months ended September 30, 2003 and 2002, respectively. The decreases from the prior year periods were partially attributable to the Sale of the Business, which resulted in costs of revenue incurred by the Business being recognized only through July 25, 2003 for the third quarter of 2003. The decreases were also attributable to lower salary and benefit costs due to the personnel reductions during 2002. Also contributing to the decrease was the absence of CheckFree software license costs in 2003 as there were no related software license sales in the same period.

General and administrative expenses directly related to the Business consisted of rent and costs of personnel providing support services for EBPP operations. These expenses decreased to $6,388 and $308,998 for the quarter and nine months ended September 30, 2003, respectively, from $231,973 and $1,229,171 for the comparable periods of 2002, respectively. The decreases from the prior year periods were partially attributable to the Sale of the Business, which resulted in such expenses incurred by the Business being recognized only through July 25, 2003 for the third quarter of 2003. The decreases were also due to lower salary and benefit costs due to the personnel reductions during 2002, and lower rental expenses under the Company's amended lease agreement.

Selling and marketing expenses directly related to the Business decreased to $54,634 and $120,833 for the quarter and nine months ended September 30, 2003, respectively, from $196,960 and $765,521 for the comparable periods of 2002, respectively. The decreases from the prior year periods were partially attributable to the Sale of the Business, which resulted in such expenses incurred by the Business being recognized only through July 25, 2003 for the third quarter of 2003. The decreases were also due to reductions in our direct sales staff.

Research and development expenses directly related to the Business consisted primarily of the cost of personnel devoted to the design of new processes that would improve our electronic presentment and payment abilities and capacities, new customer care and direct marketing services, additional business-to-consumer applications, and integration of third-party applications. These expenses decreased 91% and 79% in the third quarter and first nine months of 2003 from the prior year quarter and period, respectively. The decreases from the prior year periods were partially attributable to the Sale of the Business, which resulted in such expenses incurred by the Business being recognized only through July 25, 2003 for the third quarter of 2003. The decreases were also due to a focus on our core competencies in order to implement and service existing products.

Depreciation and amortization decreased to $43,509 and $579,227 for the quarter and nine months ended September 30, 2003, respectively, from $305,535 and $972,757 for the comparable periods of 2002, respectively. These decreases were partially attributable to the Sale of the Business, which resulted in depreciation and amortization directly related to the Business being recognized only through July 25, 2003 for the third quarter of 2003. The decreases were also due to lower depreciation related to certain assets that became fully depreciated during 2002.

Income from discontinued operations improved to $188,319 for the quarter ended September 30, 2003, from a loss of $1,128,990 for the prior year quarter. Loss from discontinued operations improved to $572,780 for the nine months ended September 30, 2003, from a loss of $3,838,351 for the comparable period of 2002. The improvements were primarily a result of the overall decrease in total operating expenses from the prior year periods.

Liquidity and Capital Resources

At September 30, 2003, the Company's principal source of liquidity consisted of $614,000 of cash and cash equivalents, compared to $286,000 of cash and cash equivalents at December 31, 2002. The Company has incurred substantial losses since inception and has experienced a material shortfall from anticipated revenues, which has led to a significant decrease in its cash position and a deficit in working capital. Also, the Company defaulted under its convertible debt agreement during the fourth quarter of 2002 and was unsuccessful in its attempt to access its funds held as collateral to guarantee certain executive margin loans after attempting to retrieve such funds during the fourth quarter of 2002. Consequently, the Company believes that its current available cash and cash equivalents along with anticipated revenues may be insufficient to meet its anticipated cash needs for the foreseeable future. Accordingly, the Company reduced expenditures for operating requirements, including a reduction of 36 employees in its workforce in November 2002, and completed the Sale of its Business in July 2003. At Closing, the Purchaser paid the Company $4,100,000 in cash. The Company may earn an additional $700,000 based upon two earnouts calculated upon gross revenues of the Business for the four consecutive quarters following the Closing, the first quarter of which begins the first day of the first full month after the Closing. Even though the purchase transaction has been completed, the Company believes that its remaining cash after payment of existing liabilities along with anticipated future revenues may be insufficient for it to continue as a going concern.

The satisfactory completion of an additional investment in the Company may be essential to provide sufficient cash flows to meet future operating requirements. 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 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 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.

As of December 31, 2002, the Company had pledged $1.3 million to collateralize certain margin loans of three officers and an ex-officer of the Company. The margin loans are from institutional lenders and are secured by shares of the Company's common stock held by these individuals. The pledged funds were classified as Cash pledged as collateral for related party obligations on the Company's balance sheet at December 31, 2002. During the quarter ended March 31, 2003, the institutional lenders applied $1,278,000 of the pledged funds being held to satisfy the outstanding balances of the loans and released the remaining

$34,000 for return to the Company. The total balance of the margin loans guaranteed by the Company was zero at September 30, 2003. The Company may institute litigation or arbitration concerning these matters, which may result in the assertion of claims by these officers under their employee agreements. The ultimate outcome of this matter cannot presently be determined.

Net cash used in operating activities was $2.1 million and $5.6 million for the nine months ended September 30, 2003 and 2002, respectively. The Company plans to focus on expending its resources prudently given its current state of liquidity and does not expect to achieve positive cash flow from continuing operations for 2003.

Net cash provided by investing activities was $4.2 million for the nine months ended September 30, 2003 and primarily reflected proceeds of approximately $4.2 million from the sale of the Business and other assets. We do not anticipate making any significant capital expenditures during the remaining three months of 2003. Net cash provided by investing activities was $173,000 for the nine months ended September 30, 2002 and primarily reflected capital expenditures of approximately $10,000 for computer equipment and software offset by the return of $189,000 of deposits which had been used to secure capital leases.

Net cash used in financing activities was $1.8 million for the nine months ended September 30, 2003 and primarily reflected the repayment of the Company's convertible debt as a condition of the sale of the Business and also included a net return of $34,000 under the Company's guarantees of related party obligations. Net cash provided by financing activities was $1.9 million for the nine months ended September 30, 2002 and included the borrowing of $1.5 million under a convertible debt agreement, and the return of $662,000 pledged as collateral for margin loans of certain officers as discussed above.

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SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Except for the historical information contained herein, the matters discussed in this Form 10-Q include certain forward-looking statements within the meaning of Section 27A of the Securities Act, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are intended to be covered by the safe harbors created thereby. Those statements include, but may not be limited to, all statements regarding our management's intent, belief and expectations, such as statements concerning our future and our operating and growth strategy. 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 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of the Annual Report on Form 10-K for the year ended December 31, 2002 and other factors detailed from time to time in our filings with the Securities and Exchange Commission. One or more of these factors have affected, and in the future could affect, our businesses and financial results in the future and could cause actual results to differ materially from plans and projections. We believe that the assumptions underlying the forward-looking statements included in this Form 10-Q will prove to be accurate. 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-Q are based on information presently available to our management. We assume no obligation to update any forward-looking statements.

Item 4. CONTROLS AND PROCEDURES

Prior to the filing date of this Quarterly Report on Form 10-Q, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934). Based on that evaluation, the Company's management, including the CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of September 30, 2003.

Part II - OTHER INFORMATION

Item 1. Legal Proceedings

On July 25, 2003, certain stockholders of the Company (such stockholders being Mike Procacci, Jr., Mark and Stefanie McMahon, Anthony and Lois Tedeschi, Donna and James Knoll, John E. Hamilton, III, William T. Hagan, Samuel A. Fruscione, Dana Fruscione-Penzone, Gia Fruscione, Alicia Fruscione, Joseph Fruscione, Robert Evans, John Arangio, Gary and JoAnne Gardner, Lee and Margaret Getson, G. Harry Bonham, Jr., Gary Brewer, Bob Lastowski, Robert Filipe, Mitchell D. Hovendick, Dr. John Diephold, Joseph Maressa, Jr., and Charles Brennan (collectively, the "Plaintiffs")) commenced legal action against the Company, Ernst & Young, LLP and certain of the Company's former directors (such directors being Louis A. Hoch, Michael R. Long, David S. Jones, Roger Hemminghaus, E. Scott Crist, Peter Kirby, Richard Bergman, and Terri A. Hunter (the "Defendant Directors")) in the District Court of the 45th Judicial District, Bexar County, Texas (the "Suit"). The Plaintiffs allege, as the Suit pertains to the Company, that the Company, acting through the Defendant Directors, misstated in the Company's 2000 and 2001 Form 10-Ks the Company's ability to use for operational purposes certain Company funds pledged as security for margin loans of three Company officers. The Plaintiffs seek economic and exemplary damages, rescission, interest, attorneys' fees, and costs of court.

The Company believes the Suit to be without merit, and intends to vigorously defend itself and the Defendant Directors.

Item 2. Changes in Securities and Use of Proceeds

Pursuant to Section 506 of Regulation D of the Securities and Exchange Act of 1933, the Company sold an aggregate of 112,500 shares of its unregistered common stock, par value $0.001, to three independent contractors in consideration for services completed on December 15, 2002, January 15, 2003, February 15, 2003, March 15, 2003, April 15, 2003, and May 15, 2003. The offers and sales the subject hereof satisfied the terms and conditions of Sections 501, 502, and 506 of the Securities and Exchange Act of 1933.

Item 4. Submission of Matters to a Vote of Security Holders

At the Special Meeting of Stockholders held on July 14, 2003, the following matters were adopted by the margins indicated:

1. To elect director Louis A. Hoch to serve until the 2006 Annual Meeting of Stockholders.

For:	18,054,816
Withheld:	746,140

2. To approve the asset purchase transaction whereby Saro, Inc., a wholly owned subsidiary of Cyberstarts, Inc., would purchase substantially all of the assets and assume certain liabilities of the Company.

For:	11,631,971
Against:	582,954
Abstain:	17,180

3. To change the Company's name from "Billserv, Inc." to "Payment Data Systems, Inc.".

For:	17,830,673
Against:	919,408
Abstain:	50,875

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4. To ratify the appointment of Ernst & Young, LLP as the independent auditors for the Company for the fiscal year ending December 31, 2003.

For:	17,747,648
Against:	1,011,233
Abstain:	42,075

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

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit Number	Description
3.1	Articles of Incorporation, as amended on July 29, 2003 (filed herewith)
10.1	Asset Purchase Agreement between the Company and Saro, Inc. dated May 15, 2003 (incorporated by reference to Appendix A in the Registrant's Definitive Proxy Statement, filed June 19, 2003)
10.2	First Amendment to Asset Purchase Agreement dated July 25, 2003 (filed herewith)

10.3 Standard Office Lease between the Company and Frost National Bank, Trustee for a Designated Trust, dated August 22, 2003 (filed herewith)

31.1 Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)

32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

(b) Reports on Form 8-K:

On July 29, 2003, the Company filed a report on Form 8-K regarding the sale of substantially all of its assets to Saro, Inc. On September 26, 2003, the Company filed an amendment to this report to include certain pro forma financial information pursuant to Item 7 of the Form 8-K.

On August 11, 2003, the Company filed a report on Form 8-K regarding legal action commenced against the Company and certain of its current and former directors by certain shareholders of the Company.

On August 19, 2003, the Company filed a report on Form 8-K regarding the change in the Company's stock symbol to "PYDS."

On September 18, 2003, the Company filed a report on Form 8-K regarding the resignation of its Chief Financial Officer and Director.

Items 3 and 5 are not applicable and have been omitted.

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.

By: /s/ Michael R. Long

Michael R. Long
Chief Executive Officer
and Chief Financial Officer
(Duly authorized and principal financial and accounting officer)

Date: November 14, 2003