

PAYMENT DATA SYSTEMS INC
Form 10-K
April 01, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2012.

TRANSITION REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 000-30152

PAYMENT DATA SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of incorporation
or organization) 98-0190072
(I.R.S. Employer Identification No.)

12500 San Pedro, Ste. 120, San Antonio, TX
(Address of principal executive offices) 78216
(Zip Code)

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

Securities registered pursuant to Section
12(b) of the Act: None.

Securities registered pursuant to Section
12(g) of the Act: Common stock, par value \$0.001 per share.
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the
Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the

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Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 29, 2012 the last business day of the registrant's second fiscal quarter, was approximately \$4,296,721, based on 53,709,014 shares of the registrant's common stock held by non-affiliates on June 29, 2012 at the closing price of \$0.08 per share. For purposes of this computation, all officers, directors and 10% beneficial owners of the registrant are deemed to be affiliates. Such determination should not be deemed an admission that such officers, directors or 10% beneficial owners are, in fact, affiliates of the registrant.

As of March 25, 2013, the number of outstanding shares of the registrant's common stock was 137,150,323.

DOCUMENTS INCORPORATED BY REFERENCE:

Not applicable.

PAYMENT DATA SYSTEMS, INC.

FORM 10-K

For the Year Ended December 31, 2012

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FACTORS THAT MAY AFFECT FUTURE RESULTS

This Annual Report on Form 10-K and the documents incorporated herein by reference contain certain forward-looking statements as defined under the federal securities laws. Specifically, all statements other than statements of historical facts included in this Annual Report on Form 10-K regarding our financial performance, business strategy and plans and objectives of management for future operations and any other future events are forward-looking statements and based on our beliefs and assumptions. If used in this report, the words "anticipate," "believe," "estimate", "expect," "intend," and words or phrases of similar import are intended to identify forward-looking statements. Such statements reflect our current view with respect to future events and are subject to certain risks, uncertainties, and assumptions, including, but without limitation, those risks and uncertainties contained in the Risk Factors section of this Annual Report on Form 10-K and our other filings made with the SEC. Although we believe that our expectations are reasonable, we can give no assurance that such expectations will prove to be correct. Based upon changing conditions, any one or more of these events described herein as anticipated, believed, estimated, expected or intended may not occur. All prior and subsequent written and oral forward-looking statements attributable to our Company or persons acting on our behalf are expressly qualified in their entirety by this cautionary statement. We do not intend to update any of the forward-looking statements after the date of this Annual Report to conform these statements to actual results or to changes in our expectations, except as required by law.

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PART I

ITEM 1. BUSINESS.

General

We were founded in July 1998 and incorporated in the State of Nevada. Our primary operations consist of functioning as a processor of electronic payments for other companies. We provide integrated electronic payment processing services to merchants and businesses, including all types of Automated Clearing House (ACH) processing, and credit and debit card-based processing services. The ACH network is a nationwide electronic funds transfer system that is regulated by the Federal Reserve and NACHA – The Electronic Payments Association and provides for the clearing of electronic payments between participating financial institutions. Our ACH processing services enable merchants or businesses to both disburse and collect funds electronically using e-checks to transfer funds instead of traditional paper checks. An e-check is an electronic debit to a bank checking account that is initiated at the point-of-sale, on the Internet, over the telephone or via a bill payment sent through the mail and is processed using the ACH network. Our card-based processing services enable merchants to process both traditional card-present, or "swipe," transactions, as well as card-not-present transactions. A traditional card-present transaction occurs whenever a cardholder physically presents a credit or debit card to a merchant at the point-of-sale. A card-not-present transaction occurs whenever the customer does not physically present a payment card at the point-of-sale and may occur over the Internet, mail, fax or telephone. Our electronic payment processing may take place in a variety of forms and situations. For example, our capabilities allow merchants to convert a paper check to an e-check or receive card authorization at the point-of-sale, allow our merchants' respective customer service representatives to take e-check or card payments from their consumers by telephone, and enable their consumers to make e-check or card payments directly through the use of a web site or by calling an Interactive Voice Response telephone system. We also operate an online payment processing service, under the domain name www.billx.com, which allows consumers to process online payments to pay any other individual, including family and friends. We also provide prepaid card processing services for merchants and consumers through our wholly-owned subsidiary, FiCentive, Inc. We offer MasterCard prepaid cards branded with corporations' logos or trademarks. These prepaid cards can be used for various applications including payroll, corporate incentives, employee incentives, and general use. Some card programs allow the cards to be reloaded with funds, while others do not have that capability. In some cases, the cards can be used at Automatic Teller Machines to withdraw cash.

We generate revenues by charging fees for the electronic processing of payment transactions and related services. We charge certain merchants for these processing services at a bundled rate based upon a percentage of the dollar amount of each transaction and, in some instances, additional fees are charged for each transaction. We charge other merchant customers a flat fee per transaction, and may also charge miscellaneous fees to our customers, including fees for returns, monthly minimums, and other miscellaneous services. We charge consumers that use our billx.com online payment service a flat monthly fee that allows them to make a certain number of payments in a month. We also charge these consumers an additional fee for each payment that exceeds the allowed number of payments in a given month. We operate solely in the United States as a single operating segment.

Our website is www.paymentdata.com. Information contained in our website does not constitute part of this annual report.

Industry Background

In the United States, the use of non-paper based forms of payment, such as credit and debit cards, has risen steadily over the past several years. According to a 2010 Federal Reserve Payments study, the estimated number of non-cash payments totaled \$108.9 billion in 2009, with a value of \$72.3 trillion. From 2006 to 2009, ACH, debit cards and

prepaid cards grew at a compound annual growth rate of 9.3%, 14.8% and 21.5%, respectively, while credit card growth remained relatively flat (down 0.2%) and use of paper checks declined by 7.2%. Electronic payments, including payments made with cards and ACH, now collectively exceed three-quarters of all non-cash payments. Banking and financial institutions enable their account holders to use more check image deposit services which is also referred to as “remote deposit capture.” As a result, traditional paper trails are being replaced by speedier, more cost-effective and eco-friendly image exchanges.

The growth of electronic commerce has made the acceptance of card-based and other electronic forms of payment a necessity for businesses, both large and small, in order to remain competitive. We believe that the electronic payment processing industry will continue to benefit from the following trends:

Favorable Demographics

As consumers age, we expect that they will continue to use the payment technology to which they have grown accustomed. More consumers are beginning to use card-based and other electronic payment methods for purchases at an earlier age. As these consumers, a demographic whom have witnessed the wide adoption of card products, technology innovations such as mobile phone payment applications, and widespread adoption of the Internet, comprise a greater percentage of the population and increasingly enter the work force, we expect purchases using electronic payment methods will comprise an increasing percentage of total consumer spending. Because of the increasing adoption rate of the Internet, businesses have a growing opportunity to conduct commerce with their consumers and business partners over the Internet. We believe the increasing usage of smartphones as an instrument of payment will also create further opportunities for us in the future.

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Increased Electronic Payment Acceptance by Small Businesses

Small businesses are a vital component of the U.S. economy and are expected to contribute to the increased use of electronic payment methods. The lower costs associated with electronic payment methods are making these services more affordable to a larger segment of the small business market. In addition, we believe these businesses are experiencing increased pressure to accept electronic payment methods in order to remain competitive and to meet consumer expectations. As a result, many of these small businesses are seeking to provide customers with the ability to pay for merchandise and services using electronic payment methods, including those in industries have historically accepted cash and checks as the only forms of payment for their merchandise and services.

Growth in Online Transactions

Market researchers expect continued growth in card-not-present transactions due to the steady growth of the Internet and electronic commerce. According to the U.S. Census Bureau, estimated retail e-commerce sales for 2012 were \$225.5 billion, an increase of approximately 16% from \$194.3 billion in 2011. We believe the prevalence of the Internet makes having an online presence a basic and necessary consideration for those operating a business today.

The growth of electronic commerce also has made the acceptance of card-based and other electronic forms of payment a necessity for today's business. Forrester Research expects that e-commerce sales in the U.S. will keep growing at a 10% compound annual growth rate through 2014, translating to online retail sales of \$250 billion, up from \$194 billion in 2011. Companies, both large and small, continue to leverage the Internet in order to remain competitive, improve operational efficiencies, create new revenue streams and maximize the longevity and profitability of their customer relationships.

Products and Services

Our service offerings are supported by our systems' infrastructure that integrates certain proprietary components with processing systems outsourced to third-party providers to offer our customers a flexible and secure payment process. We utilize a secure sockets layer architecture so that connections and information are secure from outside inspection. We also use 128-bit encryption for all electronic transactions that we process to make information unreadable as it passes over the Internet. Our systems' infrastructure allows us to work with our customers to build a customized electronic payment service offering tailored to their specific needs. We have designed and implemented our integrated payment systems to function as gateways between our customers and our third-party processing providers. Our systems provide for interfaces with our customers through which payment data is captured electronically and transferred through the connections we have with our processing providers. Our systems also provide a data warehousing capability so that all of a customers' payment data can be stored in one place to facilitate efficient data retrieval and analysis. All data stored within and without the data warehouse is fully encrypted. We outsource our ACH transaction processing and card-based transaction processing to third-party providers. Our card-based processing system is capable of connecting with all of the major card-based processors in the United States.

We recently introduced a new product offering, a mobile payment application called iRemote Pay. iRemote Pay is specifically designed for both small and large merchant customers that have a need for a remote wireless point-of-sale application to accept credit cards, debit cards, Automated Clearing House, and cash payments. The application is designed to run on iPhone, iPad, iPod Touch devices with Android and Windows platforms to be developed in the future.

The components of our service offerings include all forms of ACH transaction processing, such as Re-presented Check, or RCK, which is a consumer non-sufficient funds check that is re-presented for payment electronically rather than through the paper check collection system, and Accounts Receivable Check Conversion, which is a consumer

paper check payment that is converted into an e-check. Our customers can initiate ACH transactions directly using an online terminal accessible through a web site or we can initiate ACH transactions on their behalf. Our service offering also includes merchant account services for the processing of card-based transactions through the VISA, MasterCard, American Express, Discover, and JCB networks, including online terminal services accessed through a web site or retail services accessed via a physical terminal. We offer a proprietary web-based customer service application that combines both ACH and card processing capabilities that allows companies to process one-time and recurring payments via e-checks or credit cards at the request of their consumers. In addition, we offer an Interactive Voice Response telephone system to companies that accept payments directly from consumers over the telephone using e-checks or credit cards.

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In addition to these electronic payment services, we are a prepaid card program manager and prepaid card processor. We develop and manage prepaid card programs on behalf of corporate clients whom have customers that have a need for prepaid cards that are branded with the entity's unique logo. We hold a bank sponsorship agreement with University National Bank for our prepaid card program and started issuing cards in conjunction with the bank in October 2011. We previously held a bank sponsorship agreement with Metabank and such agreement ended according to its terms in December 2011. We also have the ability to issue Discover, American Express, Visa, and MasterCard. We primarily create, manage and process prepaid card programs for corporate clients, tailored to each client's unique objectives to allow the client to issue prepaid cards to their customer base or employees as an incentive in the form of a rebate, commission, or other incentive. We also issue general purpose reloadable, or GPR, cards to consumers as an alternative to a traditional bank account. We believe our prepaid card product offering is competitive due to our proprietary systems and the ability to implement corporate-branded card programs in a shorter time frame than most of our competitors. We believe our seven years of experience in processing and managing prepaid card programs is a competitive advantage over many of our competitors due to the industry being relatively new.

Based on the changes in the industry in 2010 due to newly enacted federal legislation specifically related to closed-loop prepaid gift cards, we have decided to no longer develop or offer this type of program. This decision has no material effect on our consolidated financial statements or business model, due to the very small amount of revenue contribution historically generated by these gift cards. Furthermore, this segment does not affect in any way our ability to continue to issue prepaid cards for general purpose reloadable cards, corporate incentive cards, payroll cards, or open-loop gift cards.

We also operate a consumer web site focused on providing bill payment services under the domain name www.billx.com, and manage all of the related back-end processing through our own proprietary processing engine. Consumers subscribe to the payment service and are allowed to make a certain number of payments each month for a flat monthly fee and are assessed a separate fee for any additional payments made over the limit. Our online payment processing service seeks to provide consumers with an efficient and secure interface for paying and managing bills via the Internet. We also sell this payment portal service as a private label solution to online financial services providers looking to provide online bill payment capabilities as part of their service offering to consumers. We also offer this service to other debit card issuers, as we are able to utilize the bill payment component of this service for payments made via debit cards, a patented process for which we own a perpetual license.

Relationships with Sponsors and Processors

We have agreements with several processors to provide to us, on a non-exclusive basis, transaction processing and transmittal, transaction authorization and data capture, and access to various reporting tools. In order to provide payment processing services for ACH transactions, we must maintain a relationship with an Originating Depository Financial Institution (ODFI) in the Automated Clearing House (ACH) network because we are not a bank and therefore not eligible to be an Originating Depository Financial Institution. For the ODFI portion of our ACH business, we use the Fifth Third Bank and the National Bank of California. Similarly, in order to provide payment-processing services for Visa, MasterCard and Discover transactions, we must be sponsored by a financial institution that is a principal member of the respective Visa, MasterCard and Discover card associations. Merrick Bank and HSBC Bank have, respectively, sponsored us under the designations Third Party Processor (TPP) and Independent Sales Organization (ISO) with the Visa card association, and under the designations Third Party Servicer (TPS) and Merchant Service Provider (MSP) with the MasterCard card association. We have an agreement with TriSource Solutions, LLC and an agreement with Global Payments, Inc. through which their member banks (Merrick Bank and HSBC) sponsor us for membership in the Visa, MasterCard, American Express, and Discover card associations and settle card transactions for our merchants. These agreements may be terminated by the processor if we materially breach the agreements and we do not cure the breach within 30 days, or if we enter bankruptcy or file for bankruptcy. We also maintain a bank sponsorship agreement with University National Bank for our prepaid card

programs. We are liable for any card-associated losses for cards that we issue that might incur a negative balance and we are liable for card association fines, fees and chargebacks.

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Under our processing agreement with TriSource Solutions, we are financially liable for all fees, fines, chargebacks and losses related to our card processing merchant customers. Under our processing agreement with Global Payments, Inc., we are not financially liable for all fees, chargebacks and losses related to our card processing merchant customers, but we are liable for potential card association fines. If, due to insolvency or bankruptcy of our merchant customers, or for another reason, we are unable to collect from our merchant customers amounts that have been refunded to the cardholders because the cardholders properly initiated a chargeback transaction to reverse the credit card charges, we must bear the credit risk for the full amount of the cardholder transaction. We utilize a number of systems and procedures to evaluate and manage merchant risk, such as obtaining approval of prospective merchants from our processor and sponsor bank, setting transaction limits and monitoring account activity. We may also require cash deposits and other types of collateral from certain merchants to mitigate any such risk. We maintain a reserve for losses resulting from card processing and related chargebacks. We estimate our potential loss for chargebacks by performing a historical analysis of our chargeback loss experience with similar merchants 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.

We maintain a separate allowance for estimated losses resulting from the inability or failure of our merchant customers to make required payments for fees charged by us. Amounts due from customers may be deemed uncollectible because of merchant disputes, fraud, insolvency or bankruptcy. We determine the allowance based on an account-by-account review, taking into consideration such factors as the age of the outstanding receivable, historical pattern of collections and financial condition of the customer. We closely monitor extensions of credit and 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.

Sales and Marketing

We market and sell our products and services through direct contact by our sales personnel, as well as through non-exclusive resellers that act as an external sales force, with minimal direct investment in sales infrastructure and management. Our direct sales effort is coordinated by a sales executive and supported by other employees who function in sales capacities. Our primary market focus is on companies generating high volumes of electronic payment transactions. We tailor our sales efforts to reach this market by pre-qualifying prospective sales leads through direct contact or market research. Our sales personnel typically initiate contact with prospective customers that we identify as meeting our target profile. We also plan to market and sell our prepaid card program directly to corporations and to consumers through the Internet. We intend to continue to analyze our sales and marketing efforts in order to control costs, increase the effectiveness of our sales force, and broaden our reach through reseller initiatives and advantageous alliances.

Customers

Our primary customers are merchants and businesses that use our Automated Clearing House and/or card-based processing services in order to provide their consumers with the ability to pay for goods and services without having to use cash or a paper check. These merchant customers operate in a variety of retail industries and are under contract with us to exclusively use the services that we provide to them. Most of our merchant customers have signed long-term contracts, generally with three-year terms, that provide for volume-based transaction fees. Our merchant accounts increased to 711 customers at December 31, 2012 from 675 customers at December 31, 2011.

We had one customer that accounted for 21% of our 2012 revenue. This customer is a reseller and represents a collection of merchants. No other customer accounted for more than 10% of revenues in 2012.

All of our customers, including those utilizing our billx.com Internet bill payment service on a recurring monthly basis to pay household bills, are consumers geographically dispersed throughout the United States. The service relationship between our billx.com customers and us is not contractual and the fee we charge for the service is not negotiable. We seek to retain customers by providing high levels of customer service. Customers also have incentive to continue using the service once activated due to their investment of time in setting up the service with their personal banking and payment information. The monthly average number of billx.com customers using our online payment service decreased to 2,876 in 2012 from 2,962 in 2011.

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Competition

The payment processing industry is highly competitive. Many small and large companies compete with us in providing payment processing services and related services to a wide range of merchants. There are a number of large transaction processors, including First Data Merchant Services Corporation, National Processing Company, and Global Payments Inc. that serve a broad market spectrum from large to small merchants and provide banking, automatic teller machine, and other payment-related services and systems in addition to card-based payment processing. There are also a large number of smaller transaction processors that provide various services to small and medium-sized merchants. Many of our competitors have substantially greater capital resources than us and operate as subsidiaries of financial or bank holding companies, which may allow them on a consolidated basis to own and conduct depository and other banking activities that we do not have the regulatory authority to own or conduct. We believe that the principal competitive factors in our market include:

quality of service;
reliability of service;
ability to evaluate, undertake and manage risk;
speed in implementing payment processes;
price and other financial terms; and
multi-channel payment capability.

We believe that our specific focus on providing integrated payment processing solutions to merchants, in addition to our understanding of the needs and risks associated with providing payment processing services electronically, gives us a competitive advantage over other competitors, which have a narrower market perspective, and over competitors of a similar or smaller size that may lack our experience in the electronic payments industry. Furthermore, we believe we present a competitive distinction through the use of our internal technology to provide a single integrated payment storage or warehouse that consolidates, processes, tracks and reports all payments regardless of payment source or channel.

Our prepaid card offering is competitive due to our proprietary systems and our ability to create and establish corporate-branded card programs in a shorter time frame than most of our competitors. We also believe our seven years of experience in processing and managing prepaid card programs is a competitive advantage over many of our competitors due to the industry being relatively new.

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Trademarks

We own federally registered trademarks on the mark “Payment Data Systems, Inc.” and its respective design. We have also secured, among others, domain name registrations for:

billx.com;
billxpress.com;
billhelp.com;
debit-service.com;
ficentive.com;
iremote-pay.com;
iremote-pay.net;
merchandise-mastercard.com;
natalie-card.com;
natalie-gift-card.com;
natalie-gulbis-mastercard.com;
natalie-gulbis-card.com;
payment-data-systems.com;
payment-data.org;
payment-data.com;
payment-recovery.com;
payment-recovery-systems.com;
parishilton-card.com;
go-green-mastercard.com;
mi-promesa.com;
pds-network.com;
prepaid-load.com;
prima-card.com;
secure-pds.com;
star-debit.com;
view-bill.com; and
zbill.com

We rely on a combination of copyright, trademark and trade secret laws, employee and third-party nondisclosure agreements, and other intellectual property protection methods to protect our services and related products.

Patents

In April 2006, we were awarded Patent Number 7,021,530 from the U.S. Patent Office for the technology and method for managing and processing bill payment via a stored-value debit card, check card, signature debit card, PIN-based card or ATM card from a variety of access points. The debit card technology for which we received patent protection allows a cardholder to use their debit or ATM card to pay local, national, or international bills with the card from their electronic balance. Because it does not require linkage to a traditional checking or savings account, this new debit technology is unique in that it allows for use by “unbanked” consumers.

On January 11, 2008, we executed an agreement to sell selected patents and patent applications, including U.S. Patent Number 7,021,530, to PCT Software Data, LLC for net proceeds of approximately \$750,000. The patents and patent applications sold relate to bill payments made with debit and stored value cards. We retained a worldwide, non-exclusive license under the patents for use with all current and future customers.

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Employees

As of December 31, 2012, we had 11 full-time employees. We are not a party to any collective bargaining agreements. We believe that our relations with our employees are very good.

ITEM 1A. RISK FACTORS.

An investment in our common stock involves a high degree of risk. You should carefully consider the following risk factors and other information included in this annual report on Form 10-K. If any of the following risks actually occur, our business, financial condition or results of operations could be materially and adversely affected and you may lose some or all of your investment.

RISKS RELATED TO OUR BUSINESS

We have generated significant losses in the past years and we have only been profitable since the third quarter of 2011.

We incurred operating losses each quarter from our inception in 1998 through the quarter ended June 30, 2011. However, we recorded both operating income and net income in the third and fourth quarters of 2011 and have continued to remain profitable for all of 2012. Additionally, we reported working capital of \$1,260,528 at December 31, 2012 compared to a working capital deficit was \$211,744 at December 31, 2011. As of December 31, 2012, our accumulated deficit was \$53,064,581. We expect to remain profitable for the foreseeable future however we have only recently become profitable and we cannot assure you we will remain profitable. We may need to raise additional capital to pursue product development initiatives and to penetrate markets for the sale of our products in the future. We believe that we have access to capital resources through possible public or private equity offerings, debt financings, corporate collaborations or other means. If the economic climate in the U.S. does not improve or deteriorates, our ability to raise additional capital could be negatively impacted. If we are unable to secure additional capital, we may be required to curtail our research and development initiatives and take additional measures to reduce costs in order to conserve our cash in amounts sufficient to sustain operations and meet our obligations. These measures could cause significant delays in our efforts to expand our product offerings and customer base in the United States, which are critical to the realization of our business plan and to future operations.

If our security applications are not sufficient to address changing market conditions and customer concerns, we may incur significant losses and be unable to sell our services.

Our use of applications designed for premium data security and integrity to process electronic transactions may not be sufficient to address changing market conditions or the security and privacy concerns of existing and potential customers. If our security applications are breached and sensitive data is lost or stolen, we could incur significant costs to not only assess and repair any damage to our systems, but also to reimburse customers for losses that occur from the fraudulent use of the data. We may also be subject to fines and penalties from the credit card associations or regulatory agencies in the event of the loss of confidential account information. Adverse publicity raising concerns about the safety or privacy of electronic transactions, or widely reported breaches of our or another provider's security, have the potential to undermine consumer confidence in the technology and could have a materially adverse effect on our business.

If we do not adapt to rapid technological change, our business may fail.

Our success depends on our ability to develop new and enhanced services and related products that meet changing customer needs. The market for our services, however, is characterized by rapidly changing technology, evolving

industry standards, emerging competition and frequent new and enhanced software, service and related product introductions. In addition, the software market is subject to rapid and substantial technological change. To remain successful, we must respond to new developments in hardware and semiconductor technology, operating systems, programming technology and computer capabilities. In many instances, new and enhanced services, products and technologies are in the emerging stages of development and marketing, and are subject to the risks inherent in the development and marketing of new software, services and products. We may not successfully identify new service opportunities, and develop and bring new and enhanced services and related products to market in a timely manner. Even if we do bring such services, products or technologies to market, they may not become commercially successful. Additionally, services, products or technologies developed by others may render our services and related products noncompetitive or obsolete. If we are unable, for technological or other reasons, to develop and introduce new services and products in a timely manner in response to changing market conditions or customer requirements, our business may fail.

We rely on our relationship with the Automated Clearing House network and if the Federal Reserve rules were to change, our business could be adversely affected.

We have contractual relationships with Fifth Third Bank and National Bank of California, both of which are Originating Depository Financial Institutions in the Automated Clearing House network. The ACH network is a nationwide batch-oriented electronic funds transfer system that provides for the interbank clearing of electronic payments for participating financial institutions. An Originating Depository Financial Institution is a participating financial institution that must abide by the provisions of the ACH Operating Rules and Guidelines. Through our relationships with Fifth Third Bank and National Bank of California, we are able to process payment transactions on behalf of our customers and their consumers by submitting payment instructions in a prescribed ACH format. We pay volume-based fees to Fifth Third Bank and National Bank of California for debit and credit transactions processed each month, and pay fees for other transactions such as returns and notices of change to bank accounts. These fees are part of our agreed-upon cost structures with the banks. If the Federal Reserve rules were to change to introduce restrictions or modify access to the Automated Clearing House, our business could be materially adversely affected. Further, if either or both of Fifth Third Bank and National Bank of California were to cancel our respective contract with the bank, our business could be materially affected. At this time, we believe we could find and enter into an agreement with another bank sponsor on similar contractual terms, but no assurances can be made. We are pursuing multiple contractual relationships with additional banks to serve as Originating Depository Financial Institutions on our behalf.

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If our third-party card processing providers or our bank sponsors fail to comply with the applicable requirements of Visa, MasterCard and Discover credit card associations, we may have to find a new third-party processing provider, which could increase our costs.

Substantially all of the card-based transactions we process involve the use of Visa, MasterCard or Discover credit cards. In order to provide payment-processing services for Visa, MasterCard and Discover transactions, we must be sponsored by a financial institution that is a principal member of the respective Visa, MasterCard and Discover card associations. Both Merrick Bank and HSBC Bank have sponsored us under the designations Third Party Processor (TPP) and Independent Sales Organization (ISO) with the Visa card association, and Third Party Servicer (TPS) and Merchant Service Provider (MSP) with the MasterCard card association. We have an agreement with TriSource Solutions, LLC and an agreement with Global Payments, Inc. through which their member banks (Merrick Bank and HSBC) sponsor us for membership in the Visa and MasterCard card associations, and settle card transactions for our merchants. If our third-party processing provider, TriSource Solutions, LLC, or our bank sponsors, Merrick Bank or HSBC Bank, fail to comply with the applicable requirements of the Visa, MasterCard, and Discover card associations, Visa, MasterCard or Discover could suspend or terminate the registration of our third-party processing provider. Also, our contract with both of these third parties is subject to cancellation upon limited notice by either party. The cancellation of our contract, termination of their registration or any changes in the Visa, MasterCard or Discover rules that would impair the registration of our third-party processing provider could require us to stop providing such payment processing services if we are unable to enter into a similar agreement with another provider or sponsor at similar costs and upon similar contractual terms. Additionally, changing our bank sponsor could adversely affect our relationship with our merchants if the new sponsor provides inferior service or charges higher costs.

Our prepaid card revenues from the sale of services to merchants that accept MasterCard cards are dependent upon our continued MasterCard registration and financial institution sponsorship and, in some cases, continued participation in certain payment networks.

In order to provide our MasterCard transaction processing services, we must be either a member of a payment network or be registered as a prepaid processor of MasterCard. University National Bank has sponsored us under the designations Third Party Servicer (TPS) and Merchant Service Provider (MSP) with the MasterCard card association. Registration as a prepaid processor is dependent upon us being sponsored by member clearing banks. If our sponsor bank should stop providing sponsorship for us, we would need to find another financial institution to provide those services or we would need to be a member, either of which could prove to be difficult and/or more expensive. If we are unable to find a replacement financial institution to provide sponsorship or become a member of the association, we may no longer be able to provide prepaid processing services to our MasterCard customers, which would negatively impact our revenues and earnings.

If we fail to comply with the applicable requirements of the respective card networks, they could seek to fine us, suspend us or terminate our registrations. If our merchants or Independent Sales Organizations (ISOs) incur fines or penalties that we cannot collect from them, we could end up bearing the cost of fines or penalties.

In order to provide our transaction processing services, we are registered with Visa, MasterCard and Discover as service providers and transaction processors for member institutions and with other networks. As such, we are subject to card association and network rules that could subject us to a variety of fines or penalties that may be levied by the card networks for certain acts or omissions. The rules of the card networks are set by their boards, which may be influenced by banks that own their stock and, in the case of Discover by the card's issuers, and some of those banks and issuers are our competitors with respect to these processing services. The termination of our registrations or our status as a service provider or transaction processor, or any changes in card association or other network rules or standards, including interpretation and implementation of the rules or standards, that increase the cost of doing

business or limit our ability to provide transaction processing services to our customers, could have a material adverse effect on our business, operating results and financial condition. If a merchant or one of our resellers fails to comply with the applicable requirements of the card associations and networks, it could be subject to a variety of fines or penalties that may be levied by the card associations or networks. If we cannot collect such amounts from the applicable merchant or one of our resellers, we could end up bearing such fines or penalties, resulting in lower earnings for us.

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We rely on a key customer and if we lose this customer, our revenues may decline.

During the year ended December 31, 2012, one customer represented 21% of our revenues. For the year ended December 31, 2011, one customer represented 44% of total revenues. This customer is not contractually obligated to continue to use our products. The loss of this customer could adversely affect our revenues.

We are subject to extensive and complex federal and state regulation and new regulations and/or changes to existing regulations could adversely affect our business.

As an agent of, and third-party service provider to, our issuing banks, we are subject to indirect regulation and direct audit and examination by the Office of Thrift Supervision, or the OTS, the Office of the Comptroller of the Currency, or the OCC, the Board of Governors of the Federal Reserve System, or the FRB, and the Federal Deposit Insurance Corporation, or the FDIC.

On March 23, 2010, the FRB issued a final rule implementing Title IV of the Credit Card Accountability, Responsibility, and Disclosure Act of 2009, or CARD Act, which imposes requirements relating to disclosures, fees and expiration dates that are generally applicable to gift certificates, store gift cards and general-use prepaid cards. We believe that our general purpose reloadable prepaid cards, and the maintenance fees charged on our general purpose reloadable cards, are exempt from the requirements under this rule, as they fall within an express exclusion for cards which are reloadable and not marketed or labeled as a gift card or gift certificate. However, this exclusion is not available if the issuer, the retailer selling the card to a consumer or the program manager, promotes, even if occasionally, the use of the card as a gift card or gift certificate. As a result, we provide retailers with instructions and policies regarding the display and promotion of our general purpose reloadable cards. It is possible, however, that despite our instructions and policies to the contrary, a retailer engaged in offering our general purpose reloadable cards to consumers could take an action with respect to one or more of the cards that would cause each similar card to be viewed as being marketed or labeled as a gift card, such as by placing our general purpose reloadable cards on a display which prominently features the availability of gift cards and does not separate or otherwise distinguish our general purpose reloadable cards from the gift cards. In such event, it is possible that such general purpose reloadable cards would lose their eligibility for such exclusion to the CARD Act and its requirements, and therefore could be deemed to be in violation of the CARD Act and the rule, which could result in the imposition of fines, the suspension of our ability to offer our general purpose reloadable cards, civil liability, criminal liability, and the inability of our issuing banks to apply certain fees to our general purpose reloadable cards, each of which would likely have a material adverse impact on our revenues.

As the laws applicable to our business, and those of our distributors and issuing banks, change frequently, are often unclear and may differ or conflict between jurisdictions, ensuring compliance has become more difficult and costly. Any failure, or perceived failure, by us, our issuing banks or our distributors to comply with all applicable statutes and regulations could result in fines, penalties, regulatory enforcement actions, civil liability, criminal liability, and/or limitations on our ability to operate our business, each of which could significantly harm our reputation and have a material adverse impact on our business, results of operations and financial condition.

State and federal legislatures and regulatory authorities have become increasingly focused upon the regulation of the financial services industry and continue to adopt new legislation which could result in significant changes in the regulatory landscape for financial institutions, which can include our bank sponsors, and other financial services companies, such as our Company. For example, the establishment of the federal Consumer Financial Protection Bureau will likely expose us to increased regulatory oversight and possibly more burdensome regulation that could have an adverse impact on our revenue and profits. In May 2012, the Consumer Financial Protection Bureau announced an intention to propose regulations regarding the prepaid card industry, although no rule has yet been published.

Our card programs are subject to strict regulation under federal law regarding anti-money laundering and anti-terrorist financing. Failure to comply with such laws, or abuse of our card programs for purposes of money laundering or terrorist financing, could have a material adverse impact on our business.

Provisions of the USA PATRIOT Act, the Bank Secrecy Act and other federal law impose substantial regulation of financial institutions designed to prevent use of financial services for purposes of money laundering or terrorist financing. Increasing regulatory scrutiny of our industry with respect to money laundering and terrorist financing matters could result in more aggressive enforcement of such laws or more onerous regulation, which could have a material adverse impact on our business. In addition, abuse of our prepaid card programs for purposes of money laundering or terrorist financing, notwithstanding our efforts to prevent such abuse through our regulatory compliance and risk management programs, could cause reputational or other harm that would have a material adverse impact on our business.

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On June 21, 2010, the Financial Crimes Enforcement Network of the U.S. Department of the Treasury, or FinCEN, issued a notice of proposed rulemaking regarding the applicability of the Bank Secrecy Act's anti-money laundering provisions to prepaid products and other matters related to the regulation of money services businesses. This rulemaking would create additional obligations for entities, including our distributors, engaged in the provision and sale of certain prepaid products, including our prepaid debit cards, such as the obligation for sellers of prepaid debit cards to obtain identification information from the purchaser at the point-of-sale. Compliance with these obligations may result in increased compliance costs for us, our issuing banks and our distributors, and may therefore have a negative impact on the profitability of our business. Additionally, the imposition of such obligations upon sellers of prepaid debit cards may cause some of our distributors to determine that they do not wish to continue offering our prepaid debit cards for sale or reload, which could also have a significant negative impact on our business. However, as the proposed rulemaking is subject to further comment and revision, it is difficult to determine with any certainty what obligations the final rulemaking might impose or what impact they might have on our business or that of our issuing banks or distributors.

Unauthorized disclosure of cardholder data, whether through breach of our computer systems or otherwise, could expose us to liability and protracted and costly litigation.

We collect and store personal identifiable information about our cardholders, including names, addresses, social security numbers, driver's license numbers and account numbers, and maintain a database of cardholder data relating to specific transactions, including account numbers, in order to process transactions and prevent fraud. As a result, we are required to comply with the privacy provisions of the Gramm-Leach-Bliley Act, various other federal and state privacy statutes and regulations, and the Payment Card Industry Data Security Standard, each of which is subject to change at any time. Compliance with these requirements is often difficult and costly, and our failure, or our distributors' failure, to comply may result in significant fines or civil penalties, regulatory enforcement action, liability to our issuing banks and termination of our agreements with one or more of our issuing banks, each of which could have a material adverse effect on our financial position and/or operations. In addition, a significant breach could result in our Company being prohibited from processing transactions for any of the relevant card associations or network organizations, including Visa, MasterCard, American Express, Discover or regional debit networks, which would also have a significant material adverse impact on our financial position and/or operations.

Furthermore, if our computer systems are breached by unauthorized users, we may be subject to liability, including claims for unauthorized purchases with misappropriated bank card information, impersonation or similar fraud claims. We could also be subject to liability for claims relating to misuse of personal information, such as unauthorized marketing purposes, or failure to comply with laws governing notification of such breaches. These claims also could result in protracted and costly litigation. In addition, we could be subject to penalties or sanctions from the relevant card associations or network organizations.

We depend on Michael R. Long and Louis A. Hoch, and if these officers ceased to be active in our management, our business may not be successful.

Our success depends to a significant degree upon the continued contributions of our key management, marketing, service and related product development and operational personnel, including our Chairman, Chief Executive Officer and Chief Financial Officer, Michael R. Long, and our President and Chief Operating Officer, Louis A. Hoch. We entered into employment agreements with Mr. Long and Mr. Hoch, respectively, in February 2007. The terms of the agreements are substantially similar and prohibit the executive from competing with us for a period of two years from the executive's date of termination. Our business may not be successful if, for any reason, either or both of these officers cease to be active in our management.

If our software fails, and we need to repair or replace it, or we become subject to warranty claims, our costs could increase.

Our software products could contain errors or "bugs" that could adversely affect the performance of services or damage a user's data. We attempt to limit our potential liability for warranty claims through technical audits and limitation-of-liability provisions in our customer agreements. However, these measures may not be effective in limiting our exposure to warranty claims. We have not experienced a significant increase in software errors or warranty claims. Despite the existence of various security precautions, our computer infrastructure may also be vulnerable to viruses or similar disruptive problems caused by our customers or third parties gaining access to our processing system. If our software fails, and we need to replace or repair it, or we become subject to warranty claims, our costs could significantly increase.

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We depend on the efficient and uninterrupted operation of our computer network systems, software, data center and telecommunications networks, as well as the systems and services of third parties. Our systems and operations or those of our third-party providers could be exposed to damage or interruption from, among other things, fire, natural disaster, power loss, telecommunications failure, terrorist acts, war, unauthorized entry, human error, and computer viruses or other defects. Defects in our systems or those of third parties, errors or delays in the processing of payment transactions, telecommunications failures or other difficulties could result in loss of revenue, loss of merchants, loss of merchant and cardholder data, harm to our business or reputation, exposure to fraud losses or other liabilities, negative publicity, additional operating and development costs, and/or diversion of technical and other resources. We perform the vast majority of disaster recovery operations ourselves, though we utilize select third parties for some aspects of recovery. To the extent we outsource our disaster recovery, we are at risk of the vendor's unresponsiveness in the event of breakdowns in our systems.

Loss of key resellers could reduce our revenue growth.

Our reseller sales channel, which purchases and resells our end-to-end services to its own portfolio of merchant customers, is a strong contributor to our revenue growth. If a reseller switches to another transaction processor, shuts down, becomes insolvent, or enters the processing business themselves, we may no longer receive new merchant referrals from the reseller, and we risk losing existing merchants that were originally enrolled by the reseller, all of which could negatively affect our revenues and earnings.

Risks associated with reduced levels of consumer spending could adversely affect our revenues and earnings.

Significant portions of our revenue and earnings are derived from fees from processing consumer ACH, prepaid, credit card and debit card transactions. We are exposed to general economic conditions that affect consumer confidence, consumer spending, consumer discretionary income or changes in consumer purchasing habits. A general reduction in consumer spending in the United States or in any other country where we do business could adversely affect our revenues and earnings. A further weakening in the U.S. economy could also force retailers to close their businesses and thus would no longer require our services, resulting in our exposure to potential credit losses and future transaction declines. Additionally, due to economic conditions, credit card issuers have been reducing credit limits and closing accounts, and are overall more selective with respect to whom they issue credit cards.

Fraud by merchants or others could have an adverse effect on our operating results and financial condition.

We have potential liability for fraudulent bankcard, ACH and prepaid card transactions or credits initiated by merchants or others. Examples of merchant fraud include when a merchant knowingly uses a stolen or counterfeit bankcard, card number or bank account to record a false sales transaction, processes an invalid bankcard, or intentionally fails to deliver the merchandise or services sold in an otherwise valid transaction. Criminals are using increasingly sophisticated methods to engage in illegal activities such as counterfeit and fraud. While we have systems and procedures designed to detect and reduce the impact of fraud, we cannot assure the effectiveness of these measures. It is possible that incidents of fraud could increase in the future. Failure to effectively manage risk and prevent fraud would increase our chargeback liability or cause us to incur other liabilities including regulatory and association fines, penalties and harm to our reputation. Increases in chargebacks or other liabilities could have an adverse effect on our operating results and financial condition.

Increases in credit card network fees may result in the loss of customers or a reduction in our earnings.

From time to time, the card networks, including Visa, MasterCard, and Discover, increase the fees (interchange and assessment fees) that they charge processors such as us. We may attempt to pass these increases along to our merchant customers, but this strategy might result in the loss of those customers to our competitors who do not pass along the

increases. If competitive practices prevent our passing along such increased fees to our merchant customers in the future, we may have to absorb all or a portion of such increases thereby increasing our operating costs and reducing our earnings.

We are subject to risks and write-offs resulting from fraudulent activities and losses from overdrawn cardholder accounts that could adversely impact our financial performance and results of operations.

Our prepaid cards expose us to threats involving the misuse of such cards, collusion, fraud, identity theft and systemic attacks on our systems. Although a large portion of fraudulent activity is addressed through the chargeback systems and procedures maintained by the card association networks, we are often responsible for other losses due to merchant and cardholder fraud. No system or procedures established to detect and reduce the impact of fraud are entirely effective and we recorded less than \$10,000 in losses due to fraud in 2012. Although we actively devote efforts to effectively manage risk and prevent fraud, we could nevertheless experience an increase in fraud losses over our historical experience.

Our cardholders can in some circumstances incur charges in excess of the funds available in their accounts and are liable for the resulting overdrawn account balance. Although we generally decline authorization attempts for amounts that exceed the available balance in a cardholder's account, the application of the card association networks' rules and regulations, the timing of the settlement of transactions and the assessment of subscription, maintenance or other fees can, among other things, result in overdrawn card accounts. As of December 31, 2012, our cardholders' overdrawn account balances totaled less than \$5,000.

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Although we maintain reserves for fraud and other losses, our exposure to these types of risks may exceed our reserve levels for a variety of reasons, including our failure to predict the actual recovery rate, failure to effectively manage risk and failure to prevent fraud. Accordingly, our business, results of operations and financial condition could be materially and adversely affected to the extent that we incur losses resulting from overdrawn cardholder accounts and fraudulent activity that exceed our designated reserves or if we determine that it is necessary to increase our reserves substantially in order to address any increased recovery risk.

Our business strategy includes identifying businesses and assets to acquire, and if we cannot integrate acquisitions into our company successfully, we may have limited growth.

Our success partially depends upon our ability to identify and acquire undervalued businesses and merchant portfolios within our industry. Although we believe that there are companies and portfolios available for potential acquisition that might offer attractive business opportunities, we may not be able to make any acquisitions, and if we do make acquisitions, they may not be profitable. As a result, our business may not grow or sustain profitability.

If we do not manage our growth, then we may not be able to sustain profitability.

In order to manage our growth successfully, we will have to continue to improve our operational, management and financial systems and expand our work force. A significant increase in our customer base may necessitate the hiring of a significant number of additional personnel, qualified candidates for which, at the time needed, may be in short supply. In addition, the expansion and adaptation of our computer and administrative infrastructure will require substantial operational, management and financial resources. Although we believe that our current infrastructure is adequate to meet the needs of our customers in the foreseeable future, we may not be able to expand and adapt our infrastructure to meet additional demand on a timely basis, at a commercially reasonable cost, or at all. If our management is unable to manage growth effectively, hire needed personnel, expand and adapt our computer infrastructure and improve our operational, management, and financial systems and controls, we may not sustain profitability.

If we do not manage our credit risks related to our merchant accounts, we may incur significant losses.

We rely on the Federal Reserve's Automated Clearing House system for electronic fund transfers and the Visa, MasterCard and Discover associations for settlement of payments by credit or debit card on behalf of our merchant customers. In our use of these established payment clearance systems, we generally bear the credit risks arising from returned transactions caused by insufficient funds, stop payment orders, closed accounts, frozen accounts, unauthorized use, disputes, customer charge backs, theft or fraud. Consequently, we assume the credit risk of merchant disputes, fraud, insolvency or bankruptcy in the event we attempt to recover funds related to such transactions from our customers. We have not experienced a significant increase in the rate of returned transactions or incurred any losses with respect to such transactions. We utilize a number of systems and procedures to manage and limit credit risks, but if these actions are not successful in managing such risks, we may incur significant losses.

Current economic conditions could have a materially adverse effect on our business.

Our operations and performance depend to some degree on economic conditions and their impact on levels of consumer spending, which have recently deteriorated significantly in many countries and regions, including the regions in which we operate, predominately in the United States, and may remain depressed for the foreseeable future. For example, some of the factors that could influence the levels of consumer spending include continuing increases in fuel and other energy costs, conditions in the residential real estate and mortgage markets, labor and healthcare costs, access to credit, consumer confidence and other macroeconomic factors affecting consumer spending behavior. These factors and other economic factors not listed could have a material adverse effect on demand for our products and on

our financial condition and operating results.

Any new or changes made to laws, regulations, card network rules or other industry standards affecting our business may require significant development efforts or have an unfavorable impact to our financial results.

Our industry is highly regulated. Any new or changes made to laws, regulations, card network rules or other industry standards affecting our business may require significant development efforts or have an unfavorable impact to our financial results. For example, in the United States, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) into law on July 21, 2010. The Dodd-Frank Act caused significant structural reforms to the financial services industry. The law regulates the fees charged or received by issuers for processing debit transactions and the transaction routing options available to merchants. On June 29, 2011, the Federal Reserve Board adopted the final rule implementing the interchange fee and routing provisions in the Dodd-Frank Act. The Dodd-Frank Act, when implemented in September of 2011, caused interchange fees to be lowered on large bank-issued debit cards. The lowered interchange had a mild negative impact on our revenues, but increased our earnings due to the fact that we were able to keep our prices constant with our merchants. If our competitors start to pass the extra margin into savings to their merchants, we may be forced to follow their actions and become exposed to lower earnings on the debit card transactions for large banks. Our prepaid cards, while some of the transactions are processed on debit networks, are currently exempt from the Dodd-Frank Act.

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RISKS RELATED TO OUR INDUSTRY

The electronic commerce market is relatively new and if it does not grow, we may not be able to sell sufficient services to make our business viable.

The electronic commerce market is a relatively new and growing service industry. If the electronic commerce market fails to grow or grows slower than anticipated, or if we, despite an investment of significant resources, are unable to adapt to meet changing customer requirements or technological changes in this emerging market, or if our services and related products do not maintain a proportionate degree of acceptance in this growing market, our business may not grow and could even fail. Additionally, the security and privacy concerns of existing and potential customers may inhibit the growth of the electronic commerce market in general, and our customer base and revenues, in particular. Similar to the emergence of the credit card and automatic teller machine industries, we and other organizations serving the electronic commerce market must educate users that electronic transactions use encryption technology and other electronic security measures that make electronic transactions more secure than paper-based transactions.

Changes in regulation of electronic commerce and related financial services industries could increase our costs and limit our business opportunities.

We believe that we are not required to be licensed by the Office of the Comptroller of the Currency, the Federal Reserve Board, or other federal or state agencies that regulate or monitor banks or other types of providers of electronic commerce services. It is possible that a federal or state agency will attempt to regulate providers of electronic commerce services, which could impede our ability to do business in the regulator's jurisdiction. Our business has also been affected by anti-terrorism legislation, such as the USA PATRIOT Act. Banking-related provisions of the USA PATRIOT Act have been implemented as additions to the banking rules regarding monetary instrument sales record keeping requirements and tracking of cash movements. In our capacity as an agent for University National Bank, the issuing bank for our prepaid card programs, we are required to comply with these rules. We are also required to implement a Customer Identification Program and establish an Anti-Money Laundering program and to report any suspected money laundering to the appropriate agencies. Our compliance with such regulations increases our responsibilities and costs associated with the administration of our debit card programs. We are also subject to various laws and regulations relating to commercial transactions, such as the Uniform Commercial Code, and may be subject to the electronic funds transfer rules embodied in Regulation E, promulgated by the Federal Reserve Board. Given the expansion of the electronic commerce market, the Federal Reserve Board might revise Regulation E or adopt new rules for electronic funds transfer affecting users other than consumers. Because of growth in the electronic commerce market, Congress has held hearings on whether to regulate providers of services and transactions in the electronic commerce market. It is possible that Congress or individual states could enact laws regulating the electronic commerce market. If enacted, such laws, rules and regulations could be imposed on our business and industry and could increase our costs or limit our business opportunities.

If we cannot compete successfully in our industry, we could lose market share and our costs could increase.

Portions of the electronic commerce market are becoming increasingly competitive. We expect to face growing competition in all areas of the electronic payment processing market. New companies could emerge and compete for merchants of all sizes. We expect competition to increase from both established and emerging companies and that such increased competition could lower our market share and increase our costs. Moreover, our current and potential competitors, many of whom have greater financial, technical, marketing and other resources than us, may respond more quickly than us to new or emerging technologies or could expand to compete directly against us in any or all of our target markets. Accordingly, it is possible that current or potential competitors could rapidly acquire market share. We may not be able to compete against current or future competitors successfully. Additionally, competitive pressures may increase our costs, which could lower our earnings, if any.

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RISKS RELATED TO OUR COMMON STOCK

Our stock price is volatile and you may not be able to sell your shares at a price higher than what you paid.

The market for our common stock is highly volatile. In 2012, our closing stock price fluctuated between \$0.06 and \$0.16. The trading price of our common stock could be subject to wide fluctuations in response to, among other things, quarterly variations in operating and financial results, announcements of technological innovations or new products by our competitors or us, changes in prices of our products and services or our competitors' products and services, changes in product mix, or changes in our revenue and revenue growth rates.

“Penny stock” rules may make buying or selling our securities difficult which may make our stock less liquid and make it harder for investors to buy and sell our shares.

Trading in our securities is subject to the SEC's "penny stock" rules and it is anticipated that trading in our securities will continue to be subject to the penny stock rules for the foreseeable future. The SEC has adopted regulations that generally define a penny stock to be any equity security that has a market price of less than \$5.00 per share, subject to certain exceptions. These rules require that any broker-dealer who recommends our securities to persons other than prior customers and accredited investors must, prior to the sale, make a special written suitability determination for the purchaser and receive the purchaser's written agreement to execute the transaction. Unless an exception is available, the regulations require the delivery, prior to any transaction involving a penny stock, of a disclosure schedule explaining the penny stock market and the risks associated with trading in the penny stock market. In addition, broker-dealers must disclose commissions payable to both the broker-dealer and the registered representative and current quotations for the securities they offer. The additional burdens imposed upon broker-dealers by these requirements may discourage broker-dealers from recommending transactions in our securities, which could severely limit the liquidity of our securities and consequently adversely affect the market price for our securities.

We have adopted certain measures that may make it more difficult for a third party to acquire control of our company.

Our Board of Directors is classified into three classes of directors serving staggered three-year terms. Such classification of the Board of Directors expands the time required to change the composition of a majority of directors and may tend to discourage a proxy contest or other takeover bid for our company. We have also instituted a stockholders rights plan that serves to help prevent a hostile takeover of our company.

ITEM 2. PROPERTIES.

Our headquarters and operations are housed in approximately 4,500 square feet of leased office space in San Antonio, Texas. Rental expense under the operating lease was approximately \$94,000 and \$94,000 for the years ended December 31, 2012 and 2011, respectively. On October 12, 2012, we executed a third amendment to our lease agreement. We originally entered into our lease agreement on August 22, 2003 and such agreement was previously amended on February 6, 2006 and October 7, 2009 on substantially similar terms. This third amendment extended the term of the lease for a period of 44 months, or until June, 30, 2016. We believe that our properties will be adequate to meet our needs through December 31, 2013.

ITEM 3. LEGAL PROCEEDINGS.

As previously disclosed in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 filed with the Securities and Exchange Commission on November 14, 2012, our wholly-owned subsidiary, FiCentive, Inc. commenced legal action against our former customer, SmartCard Marketing Systems, Inc., in the 57th Judicial District Court of Bexar County, Texas on September 17, 2012. In the complaint, we alleged, among other things, that

SmartCard Marketing Systems breached the terms of the sales agreement executed by the parties. We sought to recover economic damages of approximately \$72,000 and attorneys' fees.

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On November 25, 2012, FiCentive entered into a confidential compromise settlement agreement and full and final release with SmartCard Marketing Systems (the "Settlement Agreement"). Under the terms of the Settlement Agreement, SmartCard Marketing Systems agreed to pay FiCentive the sum of \$35,000 in immediately available funds on or before November 27, 2012. On November 27, 2012, FiCentive received the payment of \$35,000.

Additionally, pursuant to the terms of the Settlement Agreement, SmartCard Marketing Systems agreed to issue 500,000 unrestricted shares of its common stock to us by December 20, 2012. Upon receipt of both the payment of \$35,000 and the receipt of the 500,000 unrestricted common stock shares, FiCentive has agreed to dismiss the pending litigation filed on September 17, 2012 in the 57th Judicial District Court of Bexar County, Texas, with prejudice. The terms of the Settlement Agreement allow us to declare Smart Card Marketing Systems in breach of the Settlement Agreement, without notice and/or an opportunity to cure, and to proceed with the lawsuit if the \$35,000 payment or the 500,000 unrestricted common stock shares was not paid, not delivered, not paid timely, returned or recalled by SmartCard Marketing Systems, their representatives, their transfer agent, or their financial institution.

On December 17, 2012, the 500,000 unrestricted common stock shares of SmartCard Marketing Systems were tendered to us. On that same date, pursuant to the terms of the Settlement Agreement, FiCentive dismissed the pending litigation filed in the 57th Judicial District Court of Bexar County, Texas, with prejudice.

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

ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Market Information

Our common stock is quoted on the OTCQB, the OTC market tier for companies that are reporting with the SEC, and on the OTC Bulletin Board, or OTCBB, under the ticker symbol "PYDS."

The following table sets forth the high and low closing prices for our common stock for each quarter during the last two fiscal years. The prices reported below reflect inter-dealer prices and are without adjustments for retail markups, markdowns or commissions, and may not necessarily represent actual transactions.

	High	Low
2012		
First Quarter	\$ 0.110	\$ 0.060
Second Quarter	\$ 0.100	\$ 0.070
Third Quarter	\$ 0.120	\$ 0.070
Fourth Quarter	\$ 0.160	\$ 0.110
	High	Low
2011		
First Quarter	\$ 0.035	\$ 0.002
Second Quarter	\$ 0.029	\$ 0.015
Third Quarter	\$ 0.090	\$ 0.012
Fourth Quarter	\$ 0.130	\$ 0.052

Holders

As of March 25 2013, 147,721,077 shares of our common stock are issued and 137,150,323 shares outstanding. As of March 25, 2013, there were approximately 3,864 stockholders of record of our common stock.

Dividends

We have never declared or paid cash or stock dividends and have no plans to pay any such dividends in the foreseeable future, instead, we intend to reinvest our earnings, if any.

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Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information as of December 31, 2012 with respect to compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance:

	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under compensation plan
Employee Comprehensive Stock Plan approved by stockholders	2,384,421	\$ 0.11	-
Non-Employee Director Plan approved by stockholders	500,000	\$ 0.10	-
Total	2,884,421		-

Our 1999 Employee Comprehensive Stock Plan and our 1999 Non-Employee Director Plan terminated according to the respective terms of the plans in 2010. Options issued under the now terminated plans remain in effect according to the terms set on the day each option was respectively issued. No options were exercised in 2012 or 2011.

Recent Sales of Unregistered Securities; Use of Proceeds from Registered Securities

During the quarter ended December 31, 2012, we did not sell any unregistered securities.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

We did not repurchase any of our common stock during the fourth quarter of 2012.

We repurchased common stock during the first quarter of 2013. As previously disclosed, in 2002, we recognized a loss on margin loans we guaranteed for Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer, and our current Chief Executive Officer and Chief Financial Officer; and Louis A. Hoch, our President and Chief Operating Officer, in the amounts of \$535,302 and \$449,371, respectively. In February 2007, we signed employment agreements with Mr. Long and Mr. Hoch that required each to repay his respective obligation to us in four equal annual payments of cash or stock or any combination thereof.

On March 11, 2013, in accordance with our employment agreements with Mr. Long and Mr. Hoch, we accepted shares of our common stock owned by Mr. Long and Mr. Hoch as satisfaction in full for the remaining amounts owed to us as annual payments due to the loss on margin loans guaranteed by us for Mr. Long and Mr. Hoch.

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

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

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By virtue of Mr. Long and Mr. Hoch's officer positions with us, they are each considered a related party of our Company under federal securities law. Our Board of Directors has acknowledged that our entry into this agreement with Mr. Long and Mr. Hoch is a related party transaction and has approved such transactions.

ITEM 6. SELECTED FINANCIAL DATA.

As a smaller reporting company, as defined by Rule 12b-2 of the Exchange Act and in Item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this Item.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes thereto, and other financial information included elsewhere in this annual report on Form 10-K. This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. When used in this report, the words "expects," "anticipates," "suggests," "believes," "intends," "estimates," "plans," "projects," "continue," "ongoing," "potential," "expect," "predict," "be," "may," "will," "should," "could," "would," "proposal," and similar expressions are intended to identify forward-looking statements. Actual results in future periods may differ materially from those expressed or implied in such forward-looking statements as a result of a number of factors, including, but not limited to, the risks discussed under the heading "Risk Factors" in this annual report on and elsewhere in this annual report on Form 10-K.

Overview

We provide integrated electronic payment processing services to merchants and businesses, including credit and debit card-based processing services and transaction processing via the Automated Clearing House network. We also operate an online payment processing service, under the domain name www.billx.com system, which allows consumers to process online payments to pay any other individual, including family and friends. We have incurred operating losses each quarter from our inception through the quarter ended June 30, 2011. However, we have reported net income in the third and fourth quarter of 2011 and have continued to remain profitable for all of 2012 due primarily to our expanded customer base and associated increased transaction volume. At December 31, 2012, we have an accumulated deficit of approximately \$53 million. To maintain our current profitability, we must, among other things, grow and maintain our customer base, implement a successful marketing strategy, continue to maintain and upgrade our technology and transaction-processing systems, provide superior customer service, respond to competitive developments, attract, retain and motivate qualified personnel, and respond to unforeseen industry developments and other factors. We believe that our success will depend in large part on our ability to (a) manage our operating expenses, (b) add quality customers to our client base, (c) meet evolving customer requirements and (d) adapt to technological changes in an emerging market. Accordingly, we intend to focus on customer acquisition activities and outsource some of our processing services to third parties to allow us to maintain an efficient operating infrastructure and expand our operations without significantly increasing our fixed operating expenses.

Critical Accounting Policies

General

Our management's discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the

reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the reported amounts of revenues and expenses, bad debt, investments, intangible assets, income taxes, and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates under different assumptions or conditions. We consider the following accounting policies to be critical because the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change or because the impact of the estimates and assumptions on financial condition or operating performance is material.

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Revenue Recognition

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

Reserve for Processing Losses

If, due to insolvency or bankruptcy of one of our merchant customers, or for any other reason, we are not able to collect amounts from our credit card, ACH or prepaid customers that have been properly "charged back" by the customer, or if a prepaid cardholder incurs a negative balance, we must bear the credit risk for the full amount of the transaction. We may require cash deposits and other types of collateral from certain merchants to minimize any such risk. In addition, we utilize a number of systems and procedures to manage merchant risk. ACH, prepaid and credit card merchant processing loss reserves are primarily determined by performing a historical analysis of our loss experience and considering other factors that could affect that experience in the future, such as the types of transactions processed and nature of the merchant relationship with its consumers and us with our prepaid card holders. This reserve amount is subject to the risk that actual losses may be greater than our estimates. We have not incurred any significant processing losses to date. Our estimate for processing losses is likely to increase in the future as our volume of transactions processed increases. At December 31, 2012 and, 2011, our reserve for processing losses was \$214,560 and 131,544, respectively.

Bad Debts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability or failure of our customers to make required payments. We determine the allowance for doubtful accounts based on an account-by-account review, taking into consideration such factors as the age of the outstanding balance, historical pattern of collections and financial condition of the customer. Past losses incurred by us due to bad debts have been within our expectations. If the financial conditions of our customers were to deteriorate, resulting in an impairment of their ability to make contractual payments, additional allowances might be required. Our estimate for bad debt losses is likely to increase in the future as the volume of our transactions processed increases. At December 31, 2012 and, 2011, our allowance for doubtful accounts was \$50,362 and \$103,052, respectively.

Marketable Securities

We classify our marketable security investment portfolio as either held to maturity, available-for-sale, or trading. At December 31, 2012, all our marketable securities were classified as trading. Securities classified as trading are carried at fair value with unrealized gains and losses included in the consolidated statement of income. Classification as current or non-current is based primarily on whether there is an active public market for such security. Gains or losses from the sale or redemption of the marketable securities are determined using the specific identification method.

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Valuation of Long-Lived and Intangible Assets

We assess the impairment of long-lived and intangible assets periodically, or at least annually, and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important, which could trigger an impairment review, include the following: significant underperformance relative to historical or projected future cash flows; significant changes in the manner of use of the assets or the strategy of the overall business; and significant negative industry trends. When management determines that the carrying value of long-lived and intangible assets may not be recoverable, impairment is measured as the excess of the assets' carrying value over the estimated fair value. No impairment losses were recorded in 2012 or 2011.

Income Taxes

Deferred tax assets and liabilities are recorded based on the difference between financial reporting and tax bases of assets and liabilities and are measured by the enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Deferred tax assets are computed with the presumption that they will be realizable in future periods when pre-taxable income is generated. Predicting the ability to realize these assets in future periods requires a great deal of judgment by management. It is our judgment that we cannot predict with reasonable certainty that the deferred tax assets as of December 31, 2012 will be realized in future periods. Accordingly, a valuation allowance has been provided to reduce the net deferred tax assets to \$0. At December 31, 2012, we had available net operating loss carryforwards of approximately \$44 million, which expire beginning in the year 2020. Approximately \$3.5 million of the total net operating loss is subject to an IRS Section 382 limitation from 1999.

We follow ASC Topic 740-10, "Income Taxes." ASC Topic 740-10 clarified the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. ASC Topic 740-10 provides guidance regarding the recognition, measurement, presentation and disclosure in the financial statements of tax positions taken or expected to be taken on a tax return. ASC Topic 740-10 requires that only income tax benefits that meet the "more likely than not" recognition threshold be recognized. We have not recorded any unrecognized income tax benefits at December 31, 2012. Management is not aware of any tax positions that would have a significant impact on its financial position.

Results of Operations

Our revenues are principally derived from providing integrated electronic payment services to merchants and businesses, including credit and debit card-based processing services and transaction processing via the Automated Clearing House network and the program management and processing of prepaid debit cards. We also operate an online payment processing service for consumers under the domain name www.billx.com and sell this service as a private-label application to resellers. Total revenues for 2012 increased 53% to \$7,345,974 from \$4,813,257 for 2011. The increase in revenues for 2012 is primarily attributed to an increase in the number of enrolled customers and the associated increased transaction volume from card-based and ACH processing services. We increased the number of our merchant account users to 711 customers at December 31, 2012 from 675 customers at December 31, 2011. In addition, the monthly average number of consumers using our billx.com online payment service has decreased to 2,876 in 2012 from 2,962 in 2011.

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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 and sponsoring banks, we are able to process ACH 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 \$4,186,963 and \$3,093,891 for 2012 and 2011, respectively. The increase in cost of services for 2012 was primarily due to the increased variable costs related to processing our increased card-based and ACH transaction volume.

Stock-based compensation expenses decreased to \$251,830 for 2012 from \$348,768 for 2011. Our expenses for 2012 represent the reduced amount of amortization of deferred compensation expenses related to incentive stock grants to employees from previous periods partially offset by an increase due to the amortization of additional grants made in the fourth quarter of 2012.

Other selling, general and administrative expenses increased to \$1,509,333 for 2012, from \$993,877 for 2011. The increase for 2012 as compared to the prior year was principally due to higher salary expenses incurred.

Depreciation was \$6,860 for 2012, compared to \$3,722 for 2011. We capitalized \$93,956 in expenditures during 2012 and \$4,880 in 2011.

Other expense, net was \$39,761 for 2012, as compared to \$2,782 for 2011, and was primarily attributable to unrealized losses recognized on marketable securities, the common stock we hold in Commerce Planet.

Income taxes were \$76,009 and \$18,369 in 2012 and 2011, respectively, and represented the amounts incurred under the Texas margin tax as well as \$20,500 in federal income tax for 2012 as a result of the alternative minimum tax. We did not incur any federal income tax in 2011.

We reported net income of \$1,275,218 for 2012, as compared to net income of \$351,848 for 2011.

Liquidity and Capital Resources

At December 31, 2012, we had \$3,759,791 of cash and cash equivalents, compared to \$3,678,688 of cash and cash equivalents at December 31, 2011. The cash balance at December 31, 2011 included a \$500,000 certificate of deposit which collateralized our line of credit and has since matured. We incurred operating losses each quarter from our inception through June 30, 2011. However, we recorded both operating income and net income in the third and fourth quarters of 2011 and have continued to remain profitable for all of 2012. Additionally, we reported working capital of \$1,260,528 at December 31, 2012, as compared to a working capital deficit was \$211,744 at December 31, 2011. We believe the increase in number of our enrolled customers and the associated increased transaction volumes will continue to provide sufficient cash for business operations for the foreseeable future.

In November 2011, we secured a line of credit which provided a maximum borrowing of \$500,000. The credit line bore interest at 2.25% and was collateralized by a \$500,000 certificate of deposit. For the year ended December 31, 2011, total borrowings were \$300,000, which represented borrowings of \$400,000 and repayments of \$100,000 under our line of credit. For the year ended December 31, 2012, total borrowings were \$479,405 and repayments were \$779,405 which resulted in no outstanding borrowings at December 31, 2012. The line of credit and associated certificate of deposit matured on November 16, 2012. Accordingly, the line of credit expired according to its terms and the collateral was released.

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On August 21, 2007, we entered into an agreement for an equity line of credit with Dutchess Private Equities Fund, LP. Under the terms of the agreement, we were able to elect to receive as much as \$10 million from common stock purchases by Dutchess through September 10, 2012. We did not sell any shares of its common stock pursuant to the equity line of credit during 2012, 2011 or 2010. The agreement with Dutchess terminated pursuant to its terms on September 10, 2012.

On November 13, 2011, Michael Long, our Chief Executive Officer and Chief Financial Officer, and Louis Hoch, our President and Chief Operating Officer were each granted a cash bonus of \$216,000 by us pursuant to the terms of their respective employment agreements. During our fiscal year ended December 31, 2012, Mr. Long and Mr. Hoch were each granted cash bonuses totaling \$74,000 by us pursuant to the terms of their respective employment agreements.

Net cash provided by operating activities was \$475,059 for 2012 as compared to \$2,404,869 for 2011. The decrease in net cash provided by operating activities for 2012 as compared to the prior year was primarily attributable to the change in our customer deposits on hand. We plan to focus on expending our resources prudently given our current state of liquidity.

Net cash used by investing activities was \$93,956 for 2012 and \$4,880 for 2011. The increase in net cash used by investing activities for 2012 as compared to the prior year was primarily related to acquisitions of equipment.

Net cash used by financing activities for 2012 was \$300,000 and represented borrowings of \$479,405 and repayments of \$779,405 under our line of credit. Net cash provided by financing activities in 2011 was \$300,000 and represented borrowings of \$400,000 and repayments of \$100,000 under our 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 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

As a smaller reporting company as defined by Rule 12b-2 of the Exchange Act and in Item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this Item.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Payment Data Systems, Inc. and Subsidiaries
San Antonio, Texas

We have audited the accompanying consolidated balance sheets of Payment Data Systems, Inc. and its Subsidiaries (collectively referred to as the "Company") as of December 31, 2012 and 2011, and the related consolidated statements of income, changes in stockholders' equity (deficit) and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purposes of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 2012 and 2011, and the consolidated results of their operations and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ Akin, Doherty, Klein & Feuge, P.C.

Akin, Doherty, Klein & Feuge, P.C.
San Antonio, Texas
April 1, 2013

TABLE OF CONTENTSPAYMENT DATA SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS

	December 31, 2012	December 31, 2011
ASSETS		
Cash and cash equivalents	\$3,759,791	\$3,678,688
Accounts receivable, net	403,303	376,070
Prepaid expenses and other	114,699	32,164
Total current assets	4,277,793	4,086,922
Property and equipment, net	91,330	4,234
Other assets:		
Related party receivable	702,337	702,337
Marketable securities	31,467	74,787
Other assets	52,693	41,693
Total other assets	786,497	818,817
Total Assets	\$5,155,620	\$4,909,973
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$203,066	\$43,375
Accrued expenses	695,202	521,808
Customer deposits payable	2,115,122	3,429,135
Line of credit	-	300,000
Deferred revenue	3,875	4,348
Total current liabilities	3,017,265	4,298,666
Stockholders' Equity:		
Common stock, \$0.001 par value, 200,000,000 shares authorized; 147,721,077 and 142,721,077 issued and 142,725,833 and 137,725,833 outstanding	147,721	142,721
Additional paid-in capital	56,873,423	56,328,423
Treasury stock, at cost; 4,995,244 and 4,995,244 shares	(238,158)	(238,158)
Deferred compensation	(1,580,050)	(1,281,880)
Accumulated deficit	(53,064,581)	(54,339,799)
Total stockholders' equity	2,138,355	611,307
Total Liabilities and Stockholders' Equity	\$5,155,620	\$4,909,973

The accompanying notes are an integral part of these consolidated financial statements.

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PAYMENT DATA SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF INCOME

	Year ended December 31, 2012	Year ended December 31, 2011
Revenues	\$7,345,974	\$4,813,257
Operating expenses:		
Cost of services	4,186,963	3,093,891
Selling, general and administrative:		
Stock-based compensation	251,830	348,768
Other expenses	1,509,333	993,877
Depreciation	6,860	3,722
Total operating expenses	5,954,986	4,440,258
Operating income	1,390,988	372,999
Other income (expense):		
Other income (expense)	(39,761)	(2,782)
Other income (expense), net	(39,761)	(2,782)
Income before income taxes	1,351,227	370,217
Income taxes	76,009	18,369
Net Income	\$1,275,218	\$351,848
Earnings Per Share		
Basic and diluted earnings per common share:	\$0.01	\$0.00
Weighted average common shares outstanding		
Basic	133,050,998	131,988,462
Diluted	136,962,234	135,935,087

The accompanying notes are an integral part of these consolidated financial statements.

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PAYMENT DATA SYSTEMS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

	Common Stock		Additional	Treasury	Deferred	Accumulated	Total
	Shares	Amount	Paid - In Capital	Stock	Compensation	Deficit	Stockholders' Equity (Deficit)
Balance at December 31, 2010	141,073,691	\$ 141,074	\$ 56,285,070	\$(238,158)	\$ (1,630,648)	\$(54,691,647)	\$(134,309)
Purchase of treasury stock	-	-	-	-	-	-	-
Issuance of common stock	1,647,386	1,647	43,353	-	-	-	45,000
Deferred compensation	-	-	-	-	348,768	-	348,768
Net income for the year	-	-	-	-	-	351,848	351,848
Balance at December 31, 2011	142,721,077	\$ 142,721	\$ 56,328,423	\$(238,158)	\$ (1,281,880)	\$(54,339,799)	\$ 611,307
Issuance of common stock, restricted	5,000,000	5,000	545,000	-	(550,000)	-	-
Deferred compensation	-	-	-	-	251,830	-	251,830
Net income for the year	-	-	-	-	-	1,275,218	1,275,218
Balance at December 31, 2012	147,721,077	\$ 147,721	\$ 56,873,423	\$(238,158)	\$ (1,580,050)	\$(53,064,581)	\$ 2,138,355

The accompanying notes are an integral part of these consolidated financial statements.

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PAYMENT DATA SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2012	Year Ended December 31, 2011
Operating Activities		
Net income	\$1,275,218	\$351,848
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	6,860	3,722
Non-cash stock based compensation	251,830	348,768
Unrealized loss on marketable securities	63,320	24,929
Marketable securities received in litigation settlement	(20,000)	-
Issuance of stock for services provided	-	45,000
Changes in operating assets and liabilities:		
Accounts receivable	(27,233)	(238,113)
Prepaid expenses and other	(82,535)	(10,034)
Other assets	(11,000)	(2,500)
Related party receivable	-	723
Accounts payable and accrued expenses	333,085	(546,263)
Customer deposits payable	(1,314,013)	2,445,422
Deferred revenue	(473)	(18,633)
Net cash provided by operating activities	475,059	2,404,869
Investing Activities		
Purchases of property and equipment	(93,956)	(4,880)
Net cash (used) by investing activities	(93,956)	(4,880)
Financing Activities		
Proceeds from debt	479,405	400,000
Payments on debt	(779,405)	(100,000)
Net cash (used) provided by financing activities	(300,000)	300,000
Change in cash and cash equivalents	81,103	2,699,989
Cash and cash equivalents, beginning of year	3,678,688	978,699
Cash and Cash Equivalents, End of Year	\$3,759,791	\$3,678,688
Supplemental Disclosures		
Cash paid for interest	\$2,237	\$395
Cash paid for income taxes	\$13,492	\$18,369

The accompanying notes are an integral part of these consolidated financial statements.

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PAYMENT DATA SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2011 AND 2010

Note 1. Description of Business and Summary of Significant Accounting Policies

Organization: Payment Data Systems, Inc., along with its subsidiaries, Ficentive, Inc., a Nevada corporation; Zbill, Inc., a Nevada corporation; and billserv.com-Canada, Inc., a Nevada corporation, provides integrated electronic payment services, including credit and debit card-based processing services and transaction processing via the Automated Clearing House (“ACH”) network to billers and retailers. In addition, the Company operates an Internet electronic payment processing service for consumers under the domain name www.billx.com.

Principles of Consolidation and Basis of Presentation: The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates: The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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

Cash and Cash Equivalents: The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Accounts Receivable: Accounts receivables are reported at outstanding principal net of an allowance for doubtful accounts of \$50,362 and \$103,052 at December 31, 2012 and 2011, respectively. The allowance is generally determined based on historical trends and an account-by-account review. Accounts are charged off when collection efforts have failed and the account is deemed uncollectible. The Company normally does not charge interest on accounts receivable.

Marketable Securities: The Company classifies its marketable security investment portfolio as either held to maturity, available-for-sale, or trading. At December 31, 2012 and 2011, all of the Company’s marketable securities were classified as trading. Securities classified as trading are carried at fair value with unrealized gains and losses included in the consolidated statement of income. Classification as current or non-current is based primarily on whether there is an active public market for such security. Gains or losses from the sale or redemption of the marketable securities are determined using the specific identification method.

Property and Equipment: Property and equipment are stated at cost. Depreciation and amortization are computed on a straight-line method over the estimated useful lives of the related assets, ranging from three to seven years. Leasehold improvements are amortized over the lesser of the estimated useful lives or remaining lease period. Expenditures for maintenance and repairs are charged to expense as incurred.

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Concentration of Credit Risk: Financial instruments that potentially expose the Company to credit risk consist of cash and cash equivalents, and accounts receivable. The Company is exposed to credit risk on its cash and cash equivalents in the event of default by the financial institutions to the extent of balances in excess of amounts that are insured by the FDIC (\$250,000). Trade receivables potentially subject the Company to concentrations of credit risk. The Company's customer base operates in a variety of industries and is geographically dispersed, however, the relatively small number of customers increases the risk. The Company closely monitors extensions of credit and credit losses have been provided for in the consolidated financial statements and have been within management's expectations. For the year ended December 31, 2012, 21% of the Company's total revenues were from sales to one customer. This customer is a reseller and represents a collection of merchants. No other customer accounted for more than 10% of total revenues during 2012. For the year ended December 31, 2011, 44% of total revenues were from sales to one customer. This customer is a reseller and represents a collection of merchants. No other customer accounted for more than 10% of total revenues during 2011.

Fair Value of Financial Instruments: Cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and short-term borrowings are reflected in the accompanying consolidated financial statements at cost, which approximates fair value because of the short-term maturity of these instruments.

Impairment of Long-Lived Assets: The Company periodically reviews, on at least an annual basis, the carrying value of its long-lived assets, including property, plant and equipment, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. To the extent fair value of a long-lived asset, determined based upon the estimated future cash inflows attributable to the asset, less estimated future cash outflows, is less than the carrying amount, an impairment loss is recognized.

Reserve for Processing Losses: If, due to insolvency or bankruptcy of one of the Company's merchant customers, or for any other reason, the Company is not able to collect amounts from its card processing credit card, ACH or merchant prepaid customers that have been properly "charged back" by the customer or if a prepaid cardholder incurs a negative balance, the Company must bear the credit risk for the full amount of the transaction. The Company evaluates its risk for such transactions and estimates its potential processing losses based primarily on historical experience and other relevant factors. At December 31, 2012 and, 2011, the Company's reserve for processing losses was \$214,560 and \$131,544, respectively.

Advertising Costs: Advertising is expensed as incurred. The Company incurred approximately \$43,900 and \$2,500 in advertising costs in 2012 and 2011, respectively.

Income Taxes: Deferred tax assets and liabilities are recorded based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Management is not aware of any tax positions that would have a significant impact on its financial position. As with all businesses, the Company's tax returns are subject to periodic examination. The Company's federal returns for the past four years remain open to examination. The Company is subject to the Texas margin tax.

Stock-Based Compensation: The Company recognizes as compensation expense all share-based payment awards made to employees and directors, including grants of stock options and warrants, based on estimated fair values. Fair value is generally determined based on the closing price of the Company's common stock on the date of grant.

Earnings Per Share: Basic and diluted earnings per common share are calculated by dividing earnings by the weighted average number of common shares outstanding during the period.

Note 2. Equity Line of Credit

On August 21, 2007, the Company entered into an agreement for an equity line of credit with Dutchess Private Equities Fund, LP (“Dutchess”). Under the terms of the agreement, at its election, the Company was able to receive as much as \$10 million in common stock purchases by Dutchess over a period of five years. The Company agreed to file a registration statement with the Securities and Exchange Commission (“SEC”), and have it declared effective before any funds may be received under the agreement, in order to register the resale of the shares of the Company’s common stock to be issued to Dutchess. The Company filed a registration statement on Form SB-2 with the SEC on August 23, 2007 and it was declared effective on September 10, 2007. The Company did not sell any shares of its common stock pursuant to the equity line of credit during 2012, 2011 or 2010. The agreement with Dutchess terminated pursuant to its terms on September 10, 2012.

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Note 3. Line of Credit:

In November 2011, the Company secured a line of credit, which provided a maximum borrowing of \$500,000. The credit line bore interest at 2.25% and was collateralized by a \$500,000 certificate of deposit. For the year ended December 31, 2011, total borrowings were \$300,000, which represented borrowings of \$400,000 and repayments of \$100,000 under the line of credit. For the year ended December 31, 2012, total borrowings were \$479,405 and repayments were \$779,405 which resulted in no outstanding borrowings at December 31, 2012. The line of credit and associated certificate of deposit matured on November 16, 2012. Accordingly, the line of credit expired according to its terms and the collateral was released.

Note 4. Fair Value Measurements

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

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

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

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

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

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

	December 31, 2012			
Recurring Fair Value Measures Assets:	Level 1	Level 2	Level 3	Total
Marketable securities	\$ 31,467	-	-	\$ 31,467
Liabilities:				
None	-	-	-	-
	December 31, 2011			
Recurring Fair Value Measures Assets:	Level 1	Level 2	Level 3	Total
Marketable securities	\$ 74,787	-	-	\$ 74,787
Liabilities:				
None	-	-	-	-

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

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Note 5. Property and Equipment

The following is a summary of property and equipment at December 31:

	2012	2011
Furniture and fixtures	\$ 175,856	\$ 175,856
Equipment	594,391	506,457
Software	332,337	326,315
Leasehold improvements	15,992	15,992
Total property and equipment	1,118,576	1,024,620
Less: accumulated depreciation	(1,027,246)	(1,020,386)
Net property and equipment	\$ 91,330	\$ 4,234

Note 6. Valuation Accounts:

Valuation and allowance accounts include the following at December 31:

	Balance Beginning of Year	Net Charged to Costs and Expenses	Transfers	Net Write-Off	Balance End of Year
2012					
Allowance for doubtful accounts	\$ 103,042	\$ -	\$ -	\$ (52,680)	\$ 50,362
Reserve for processing losses	131,544	83,016	-	-	214,560
2011					
Allowance for doubtful accounts	\$ 51,442	\$ -	\$ 75,000	\$ (23,400)	\$ 103,042
Reserve for processing losses	205,400	1,144	(75,000)	-	131,544

Note 7. Accrued Expenses

Accrued expenses consist of the following balances at December 31:

	2012	2011
Accrued salaries	\$ 142,257	\$ 135,768
Reserve for merchant losses	214,560	131,544
Accrued commissions	78,071	132,798
Accrued taxes	92,849	40,319
Other accrued expenses	167,465	81,379
Total accrued expenses	\$ 695,202	\$ 521,808

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Note 8. Operating Leases

The Company has a lease for approximately 4,500 square feet that houses its headquarters and operations. Rental expense under the operating lease was approximately \$94,000 and \$94,000 for the years ended December 31, 2012 and 2011, respectively. On October 12, 2012, the Company executed a third amendment to its lease agreement. We originally entered into our lease agreement on August 22, 2003 and such agreement was previously amended on February 6, 2006 and October 7, 2009 on substantially similar terms. The third amendment extended the lease agreement for a period of 44 months, or until June 30, 2016. Future minimum lease payments at December 13, 2012 are as follows:

Year ending December 31	
2013	\$ 75,117
2014	92,018
2015	94,271
2016	47,324

Note 9. Related Party Transactions

Mr. Michael R. Long and Louis A. Hoch

As previously disclosed, in 2002, the Company recognized a loss on margin loans it guaranteed for Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer, and the Company's current Chief Executive Officer and Chief Financial Officer; and Louis A. Hoch, the Company's President and Chief Operating Officer, in the amounts of \$535,302 and \$449,371, respectively. In February 2007, the Company signed employment agreements with Mr. Long and Mr. Hoch that required each to repay his respective obligation to the Company in four equal annual payments of cash or stock or any combination thereof. In December 2007, the Company accepted common stock and stock options valued at \$133,826 and \$112,343 from Mr. Long and Mr. Hoch, respectively, in satisfaction of their annual payments for 2007 as provided for under their respective employment agreements.

In December 2008, Mr. Long and Mr. Hoch did not pay the Company the second annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because the Company had deferred payment of their salary increases for 2008 called for under their respective employment agreements. At December 31, 2008, the Company owed Mr. Long and Mr. Hoch deferred salaries of \$110,000 and \$100,000, respectively, and Mr. Long and Mr. Hoch owed the Company \$133,825 and \$112,343, respectively, for the second installment of their loan repayments. The total amount owed to the Company for the second installment was \$246,168 and is classified as "Related Party Receivable" on the Company's balance sheet at December 31, 2008. On March 30, 2009, the Company accepted 680,715 shares of the Company's common stock valued at \$23,825 and 352,658 shares of the Company's common stock valued at \$12,343 from Mr. Long and Mr. Hoch, respectively, in partial satisfaction of their annual payments due to the Company for 2008 as provided for under their employment agreements. The partial payments of \$23,825 and \$12,343 made to the Company by Mr. Long and Mr. Hoch, respectively, equaled the difference between the amount each owed to the Company for the second installment of their loan repayments and the amount the Company owed to each executive as deferred salary. The common stock accepted from Mr. Long and Mr. Hoch was valued at \$0.035 per share, which was the closing price of the common stock on March 30, 2009. The common stock accepted from Mr. Long and Mr. Hoch was recorded as treasury stock with a total cost of \$36,168.

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

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

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On April 12, 2010, the Company executed a second amendment to its employment agreements with Mr. Long and Mr. Hoch. Under the terms of the second amendment to their respective amended employment agreements, Mr. Long and Mr. Hoch agreed to reduce their annual base salaries for 2010 to \$24,000 each from \$375,000 and \$350,000, respectively, and to change their annual bonus limit from 100% of current salary to 100% of the highest salary received in any year of the agreement.

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

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

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

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

As of December 31, 2012, Mr. Long owed the Company \$377,651 and Mr. Hoch owed the Company \$324,686. The total amount for the unpaid installments of \$702,337 is classified as "Related Party Receivable" on the Company's balance sheet at December 31, 2012.

On March 11, 2013, in accordance with the Company's employment agreements with Mr. Long and Mr. Hoch, the Company accepted shares of the Company's common stock owned by Mr. Long and Mr. Hoch as satisfaction in full for the remaining amounts owed to the Company as annual payments due to the loss on margin loans guaranteed by the Company for Mr. Long and Mr. Hoch (see Note 15).

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

Accordingly, on March 11, 2013, the Company accepted an aggregate of 2,969,459 shares of the Company's common stock valued at \$534,503, and an aggregate of 2,606,051 shares of the Company's common stock valued at \$469,089 from Mr. Long and Mr. Hoch, respectively, as satisfaction in full of their aggregated outstanding amounts of \$702,337 owed to the Company and aggregated compensation of \$301,255 paid to Mr. Long and Mr. Hoch in lieu of cash bonuses. The common stock accepted from Mr. Long and Mr. Hoch was valued at \$0.18 per share, which was the

closing price of the common stock on March 1, 2013. The common stock accepted from Mr. Long and Mr. Hoch was recorded as treasury stock and the Company no longer carries a "Related Party Receivable" on its balance sheet.

Herb Authier

During the years ended December 31, 2012 and 2011, the Company paid Herb Authier a total of \$31,250 and \$30,000 in cash, respectively, for services related to network engineering and administration that he provided to the Company. Mr. Authier is the father-in-law of Louis Hoch, the Company's President and Chief Operating Officer.

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Note 10. Income Taxes

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows at December 31:

	2012	2011
Gross deferred tax assets:		
Net operating loss carryforwards	\$ 14,694,000	\$ 15,100,000
Depreciation and other items	36,000	70,000
Total deferred tax assets	14,730,000	15,170,000
Gross deferred tax liabilities:		
Other items	-	(2,000)
Total deferred tax liabilities	-	(2,000)
Net deferred tax asset	14,730,000	15,168,000
Less: valuation allowance	(14,730,000)	(15,168,000)
Net deferred tax asset recorded	\$ -	\$ -

Management has reviewed its net deferred asset position, and due to the history of operating losses has determined that the application of a full valuation allowance at December 31, 2012 and December 31, 2011 is warranted. If applicable, the Company would recognize interest expense and penalties related to uncertain tax positions in interest expense. As of December 31, 2012, the Company had not accrued any interest or penalties related to uncertain tax provisions.

The Company has net operating loss carryforwards for tax purposes of approximately \$44 million that begin to expire in the year 2020. Approximately \$3.5 million of the total net operating loss is subject to an IRS Section 382 limitation from 1999.

The reconciliation of federal income tax computed at the U.S. federal statutory tax rates to total income tax expense is as follows for the year ended December 31:

	2012	2011
Tax (benefit) at statutory rate -- 34%	\$ 424,000	\$ 138,000
Change in valuation allowance	(438,000)	(2,960,000)
Permanent and other differences	14,000	2,822,000
Alternative minimum tax	20,500	-
Income tax expense	\$ 20,500	\$ -

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Note 11. Stock Options, Incentive Plans, Stock Awards, and Employee Benefit Plan

Stock Option Plans: The Company's 1999 Employee Comprehensive Stock Plan ("Employee Plan") provides qualified incentive stock options ("ISOs") and non-qualified stock options ("NQSOs") as well as restricted stock grants to key employees. Under the terms of the Employee Plan, the exercise price of ISOs must be equal to 100% of the fair market value on the date of grant (or 110% of fair market value in the case of an ISO granted to a 10% stockholder/grantee). There is no price requirement for NQSOs, other than that the option price must exceed the par value of the common stock. The Company reserved 30,000,000 shares of its common stock for issuance pursuant to the Employee Plan. The Employee Plan terminated in 2010.

The 1999 Non-Employee Director Plan ("Director Plan") was approved by the Board of Directors and stockholders to provide non-employee directors options to purchase shares of common stock at 100% of fair market value on the date of grant. The Company reserved 1,500,000 shares of its common stock for issuance pursuant to the Director Plan. The Director Plan terminated in 2010.

The Company currently has no active stock option or incentive plan under which options or shares may be issued. Options issued under the now terminated Plans remain in effect according to the terms set on the day each option was respectively issued. No options were exercised in 2012 or 2011. A summary of option activity is as follows:

Options	Shares	Weighted Average Exercise Price	Weighted Average Contractual Remaining Life	Aggregate Intrinsic Value
Outstanding, December 31, 2011	2,998,921	\$ 0.11		
Granted	-	-		
Vested	-	-		
Forfeited	(114,500)	\$ 0.18		
Outstanding, December 31, 2012	2,884,421	\$ 0.11	1.97	\$ 78,038
Expected to Vest After December 31, 2012	2,884,421	\$ 0.11	1.97	\$ 78,038

Stock Awards: The Company has granted restricted stock awards to its employees at different periods from 2005 through 2012. The shares granted to those employees vest at 10 years from the grant date, and are forfeited in the event that the recipient's employment relationship with the Company is terminated prior to vesting. The fair value of the restricted stock award granted to the Company's employees is amortized to expense on a straight-line basis over the vesting period of the restricted stock award. Restricted stock awards are issued and reported as outstanding in the financial statements for 2012 and 2011 as of the date that the physical shares were issued to the employee by the Company's transfer agent. Stock based compensation expense related to stock options and restricted stock awards was \$251,830 for 2012 and \$348,768 for 2011. The following table presents a summary of the Company's restricted stock awards outstanding at December 31, 2012:

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Stock Awards	Shares	Weighted Average Exercise Price	Weighted Average Contractual Remaining Life	Aggregate Intrinsic Value
Outstanding, December 31, 2011	40,681,301	\$0.07		
Granted	5,000,000	\$0.11		
Vested	-	-		
Forfeited	-	-		
Outstanding, December 31, 2012	45,681,301	\$0.08	4.96	\$-
Expected to Vest After December 31, 2012	45,681,301	\$0.08	4.96	\$-

As of December 31, 2012, there was approximately \$1,580,000 of total unrecognized compensation costs related to the unvested share-based compensation arrangements granted. The cost is expected to be recognized over the weighted average remaining contractual life of 4.96 years.

Employee Stock Purchase Plan: The Company established the 1999 Employee Stock Purchase Plan ("ESPP") under the requirements of Section 423 of the Internal Revenue Code (the "Code") to allow eligible employees to purchase the Company's common stock at regular intervals. Participating employees may purchase common stock through voluntary payroll deductions at the end of each participation period at a purchase price equal to 85% of the lower of the fair market value of the common stock at the beginning or the end of the participation period. Common stock reserved for future employee purchases under the plan aggregated 755,828 shares at December 31, 2012. No shares were issued pursuant to the ESPP in 2012 or 2011.

401(k) Plan: The Company has a defined contribution plan (the "401(k) Plan") pursuant to Section 401(k) of the Code. All eligible full and part-time employees of the Company who meet certain age requirements may participate in the 401(k) Plan. Participants may contribute between 1% and 15% of their pre-tax compensation, but not in excess of the maximum allowable under the Code. The 401(k) Plan allows for discretionary and matching contributions by the Company. The Company did not make any matching contributions in 2012 or 2011.

Note 12. Earnings per Share:

Basic earnings per share (EPS) were computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted EPS differs from basic EPS due to the assumed conversion of potentially dilutive options that were outstanding during the period. The following is a reconciliation of the numerators and the denominators of the basic and diluted per share computations for net income.

	2012	2011
Numerator:		
Numerator for basic and diluted earnings per share, net income available to common shareholders	\$1,275,218	\$351,848
Denominator:		
Denominator for basic earnings per share, weighted average shares outstanding	133,050,998	131,988,462
Effect of dilutive securities-stock options and restricted awards	3,911,236	3,946,625
Denominator for diluted earnings per share, adjusted weighted average shares and assumed conversion	136,962,234	135,935,087

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Basic earnings per common share	\$0.01	\$0.00
Diluted earnings per common share and common share equivalent	\$0.01	\$0.00

Options to purchase shares of common stock that were outstanding at December 31, 2012 and 2011 that were not included in the computation of diluted earnings per share because the effect would have been antidilutive, are as follows:

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	2012	2011
Anti-dilutive options	1,335,000	1,349,500

Note 13. Stock Warrants

There were no outstanding warrants as of December 31, 2012 or December 31, 2011.

Note 14. Legal Proceedings

SmartCard Marketing Systems, Inc.

As previously disclosed in the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 filed with the Securities and Exchange Commission on November 14, 2012, the Company's wholly-owned subsidiary, FiCentive, Inc. commenced legal action against its former customer, SmartCard Marketing Systems, Inc., in the 57th Judicial District Court of Bexar County, Texas on September 17, 2012. In the complaint, the Company alleged, among other things, that SmartCard Marketing Systems breached the terms of the sales agreement executed by the parties. The Company sought to recover economic damages of approximately \$72,000 and attorneys' fees.

On November 25, 2012, FiCentive entered into a confidential compromise settlement agreement and full and final release with SmartCard Marketing Systems (the "Settlement Agreement"). Under the terms of the Settlement Agreement, SmartCard Marketing Systems agreed to pay FiCentive the sum of \$35,000 in immediately available funds on or before November 27, 2012. On November 27, 2012, FiCentive received the payment of \$35,000.

Additionally, pursuant to the terms of the Settlement Agreement, SmartCard Marketing Systems agreed to issue 500,000 unrestricted shares of its common stock to the Company by December 20, 2012. Upon receipt of both the payment of \$35,000 and the receipt of the 500,000 unrestricted common stock shares, FiCentive has agreed to dismiss the pending litigation filed on September 17, 2012 in the 57th Judicial District Court of Bexar County, Texas, with prejudice. The terms of the Settlement Agreement allowed us to declare Smart Card Marketing Systems in breach of the Settlement Agreement, without notice and/or an opportunity to cure, and to proceed with the lawsuit if the \$35,000 payment or the 500,000 unrestricted common stock shares were not paid, not delivered, not paid timely, returned or recalled by SmartCard Marketing Systems, their representatives, their transfer agent, or their financial institution.

On December 17, 2012, the 500,000 unrestricted common stock shares of SmartCard Marketing Systems were tendered to the Company. On that same date, pursuant to the terms of the Settlement Agreement, FiCentive dismissed the pending litigation filed in the 57th Judicial District Court of Bexar County, Texas, with prejudice.

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Note 15. Subsequent Events

As previously disclosed, in 2002, the Company recognized a loss on margin loans it guaranteed for Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer, and the Company's current Chief Executive Officer and Chief Financial Officer; and Louis A. Hoch, the Company's President and Chief Operating Officer, in the amounts of \$535,302 and \$449,371, respectively. In February 2007, the Company signed employment agreements with Mr. Long and Mr. Hoch that required each to repay his respective obligation to the Company in four equal annual payments of cash or stock or any combination thereof.

As of December 31, 2012, Mr. Long owed the Company \$377,651 and Mr. Hoch owed the Company \$324,686. The total amount for the unpaid installments of \$702,337 is classified as "Related Party Receivable" on the Company's balance sheet at December 31, 2012.

On March 11, 2013, in accordance with the Company's employment agreements with Mr. Long and Mr. Hoch, the Company accepted shares of the Company's common stock owned by Mr. Long and Mr. Hoch as satisfaction in full for the remaining amounts owed to the Company as annual payments due to the loss on margin loans guaranteed by the Company for Mr. Long and Mr. Hoch. These amounts are described in further detail in Note 9.

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

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

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer / Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this Annual Report on Form 10-K. Based on that evaluation, our Chief Executive Officer / Chief Financial Officer concluded that our disclosure controls and procedures as of December 31, 2012 are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer / Chief Financial Officer, as appropriate, to allow timely decisions regarding required reasonable assurance that such information is accumulated and communicated to our management. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management. Our 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.

Management’s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for our Company. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our management conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2012 based on criteria established in “Internal Control—Integrated Framework” issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, our management concluded that, as of December 31, 2012, our internal control over financial reporting was effective.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the quarter ended December 31, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION.

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

Set forth below is certain information with respect to the individuals who are our executive officers and/or directors as of December 31, 2012:

Michael R. Long, age 68 - Chief Executive Officer, Chief Financial Officer and Chairman of the Board

Mr. Long has served as our Chief Executive Officer and Chairman of our Board of Directors since July 1998. He has also held the position of our Chief Financial Officer since September 2003, in addition to his other positions with us. Mr. Long has more than thirty years of senior executive management and systems development experience in six publicly traded companies, as well as experience operating a systems consulting business. Before assuming the highest position with our Company, Mr. Long was Vice President of Information Technology at Billing Concepts, Inc., the largest third party billing clearinghouse for the telecommunications industry. Mr. Long's career experience also includes financial services industry business development for Anderson Consulting and several executive positions in publicly traded telecommunications and financial services companies. Mr. Long is a valuable member of our Board due to his depth of operating, strategic, systems development, transactional, and senior management experience in our industry. Additionally, Mr. Long has held positions of increasing responsibility at our Company and holds an intimate knowledge of our Company due to his longevity in the industry and with us.

Louis A. Hoch, age 47 - President, Chief Operating Officer and Vice Chairman of the Board

Mr. Hoch has served as our President, Chief Operating Officer, and a director of our Company since July 1998, and also serves as Vice Chairman of our Board of Directors and as Chief Executive Officer of our wholly-owned subsidiary FiCentive, Inc. Mr. Hoch is a valuable member of our Board as he has over twenty years of management experience, sixteen years of which were at a senior executive level in large systems development, and he is an expert in payment processing, call center operations and service bureau operations. He holds inventor status on U.S. Patent 7,021,530 ("System and method for managing and processing stored-value cards and bill payment therefrom."). Mr. Hoch has held various key management positions with U.S. Long Distance, Billing Concepts, Inc. and Anderson Consulting. Mr. Hoch holds a BBA in Computer Information Systems and an MBA in International Business Management, both from Our Lady of the Lake University Business School.

Larry Morrison, age 53 - Vice President, Sales and Marketing Officer

Mr. Morrison has served as our Vice President, Sales and Marketing Officer since July 2003. Mr. Morrison has over twenty-five years of experience in all aspects of sales and sales management. Before joining our Company to oversee all sales and marketing functions, Mr. Morrison served as a major accounts executive for a tier one telecommunications provider and vice president of sales and operations for a major two-way communications firm. His background also includes management and implementation of large government communication systems installations both domestic and abroad.

Peter G. Kirby, Ph.D. SPHR CM, age 73 - Director

Dr. Kirby has served a director of our Company since June 2001. Dr. Kirby has distinguished himself in professional and community activities in a career that spanned over thirty-five years. He is an accomplished public speaker and has provided consulting services to Fortune 100 firms. Dr. Kirby has published numerous works in the fields of management, decision-making and human resources. He has been a director on many university advisory councils and boards and has served on many charitable committees and foundations. Dr. Kirby retired in 2006 as a tenured

professor of management at Our Lady of the Lake University in San Antonio, Texas, where he taught for seventeen years. Dr. Kirby served as Chair of the QFN Economic Development Corporation, a Canadian corporation, from April 2007 to May 2008. Dr. Kirby is a valuable member of our Board due to his depth of strategic and management experience.

OTHER INVOLVEMENT IN CERTAIN LEGAL PROCEEDINGS

None of our directors or executive officers have been involved in any bankruptcy or criminal proceedings, nor have there been any judgments or injunctions brought against any of our directors or executive officers during the last ten years that we consider material to the evaluation of the ability and integrity of any director or executive officer.

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SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our directors, executive officers and persons who own more than 10% of a registered class of our securities to file reports of beneficial ownership and changes in beneficial ownership with the Securities and Exchange Commission on Forms 3 (Initial Statement of Beneficial Ownership), 4 (Statement of Changes of Beneficial Ownership of Securities) and 5 (Annual Statement of Beneficial Ownership of Securities). Officers, directors and greater than 10% beneficial owners are required by SEC regulations to furnish us with copies of all Section 16(a) forms they file. To our knowledge, based solely on a review of copies of such reports furnished to us by our officers and directors, we believe that, during the fiscal year ended December 31, 2012, no person required to file reports under Section 16(a) of the Securities Exchange Act of 1934 failed to file such reports on a timely basis during such fiscal year except twelve Form 4s filed by Mr. Hoch were late by 1 day, eight Form 4s were late by 2-3 days and one Form 4 was late by 7 days. All the trades were executed under a 10(b)5-1 trading plan in which Mr. Hoch did not specify any specific trading days or trading conditions that would give him knowledge of when a trade should occur. As a result, Mr. Hoch was not aware of trade executions in a timely manner.

CODE OF ETHICS

We have adopted a Code of Ethics that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions. Our code of ethics is filed as Exhibit 14.1 to our annual report on Form 10-K for the year ended December 31, 2003. We will provide a copy of our code of ethics to any person without charge, upon request. Requests should be addressed to: Payment Data Systems, Inc., Attn: Investor Relations Department, 12500 San Pedro, Suite 120, San Antonio, Texas 78216.

PROCEDURE FOR NOMINATING DIRECTORS

We have not made any material changes to the procedures by which security holders may recommend nominees to our Board of Directors.

We consider recommendations for director candidates from our directors, officers, employees, stockholders, customers and vendors. Stockholders wishing to nominate individuals to serve as directors may submit such nominations, along with a nominee's qualifications, to our Board of Directors at Payment Data Systems, Inc., 12500 San Pedro, Suite 120, San Antonio, Texas, 78216, and the Board of Directors will consider such nominee. The Board of Directors selects the director candidates slated for election. We do not have a separately designated nominating committee in light of resource allocations made by the Board of Directors in its business judgment.

COMMITTEES OF THE BOARD OF DIRECTORS

The Board of Directors has the responsibility for establishing broad corporate policies and reviewing our overall performance rather than day-to-day operations. The Board's primary responsibility is to oversee management of our Company and, in so doing, serve the best interests of our Company and our stockholders.

AUDIT COMMITTEE

We have a separately designated audit committee, and its membership consists solely of our independent director, Dr. Peter Kirby. We do not currently have an "audit committee financial expert," as defined in Item 407(d)(5)(ii) of Regulation S-K serving on our Audit Committee. We have been unable to find a suitable replacement for the independent director who previously served on the Audit Committee and satisfied the definition of "audit committee financial expert." We are still seeking an independent director to serve as the audit committee financial expert and to

serve on the Audit Committee alongside Dr. Kirby.

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ITEM 11. EXECUTIVE COMPENSATION.

SUMMARY COMPENSATION

The following table sets forth the compensation for the fiscal years ended December 31, 2012 and 2011 awarded to, earned by, or paid to (i) our Principal Executive Officer; and (ii) our two most highly compensated executive officer. We refer to the individuals included in the Summary Compensation Table as our “named executive officers.”

Summary Compensation Table for the Fiscal Years Ended December 31, 2012 and 2011

Name and Principal Position	Year Ended Dec. 31,	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Nonequity Incentive Awards		Nonqualified Deferred Compensation		Other Compensation (\$)(2)	Total (\$)
					Option Awards (\$)(1)	Plan Compensation (\$)	Salary (\$)	Other Compensation (\$)		
Michael R. Long Chairman, Chief Executive Officer and Chief Financial Officer	2012	217,699 (3)	74,000 (4)	78,998 (5)	-	-	-	12,117	382,814	
	2011	24,000 (6)	216,000(7)	131,592(5)	-	-	-	12,117	383,709	
Louis A. Hoch Vice Chairman, President and Chief Operating Officer	2012	199,692(8)	74,000 (9)	99,182 (5)	-	-	-	2,520	375,394	
	2011	24,000 (10)	216,000(11)	151,776(5)	-	-	-	2,520	394,296	
Larry Morrison Vice President, Sales and Marketing Officer	2012	110,000	12,000	14,870 (13)	-	-	-	1,008	137,878	
	2011	45,500	20,000	13,632 (12)	-	-	-	1,008	80,140 (12)	

(1) There were no stock options granted to any of our named executive officers during fiscal year 2012 or 2011.

- (2) This column reflects premiums paid by us for term life insurance coverage on behalf of the named executive officer.
- (3) In 2012, Mr. Long elected to receive a base salary of \$190,000 per annum in lieu of the base salary of \$375,000 that would have been due for 2012 under the employment agreement effective February 27, 2007. On July 2, 2012, we executed a fourth amendment to our employment agreement with Mr. Long. Under the terms of the fourth amendment to the employment agreement, Mr. Long agreed to amend his annual base salary for 2012 to \$255,000 from \$375,000. Total base salary earned by Mr. Long for 2012 was \$217,699.

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- (4) Mr. Long's 2012 bonus compensation consisted of: (a) a one-time cash bonus of \$10,000 on May 24, 2012; (b) a one-time cash bonus of \$10,000 on September 17, 2012; and (c)) a one-time cash bonus of \$54,000 on November 1, 2012. All bonus compensation was granted pursuant to the terms of our employment agreement with Mr. Long, as amended.
- (5) In this column, the figure represents the amount recognized by the executive during this period for financial statement reporting purposes only and is not compensation earned by the executive. The fair value of each restricted stock award is amortized to expense on a straight-line basis over the vesting period of the restricted stock award. The aggregate grant date fair value of the stock award was calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718. See Note 11 of the Notes to our Financial Statements contained elsewhere in this annual report on Form 10-K for a discussion of all assumptions made by us in determining values of our stock awards.
- (6) On January 14, 2011, we executed a third amendment to our employment agreement with Mr. Long. Under the terms of the third amendment to the employment agreement, Mr. Long agreed to reduce his annual base salary for 2011 to \$24,000 from \$375,000.
- (7) On November 13, 2011, Mr. Long was granted a one-time cash bonus of \$216,000 by us pursuant to the terms of our employment agreement with Mr. Long, as amended.
- (8) In 2012, Mr. Hoch elected to receive a base salary of \$175,000 per annum in lieu of the base salary of \$350,000 that would have been due for 2012 under the employment agreement effective February 27, 2007. On July 2, 2012, we executed a fourth amendment to our employment agreements with Mr. Hoch. Under the terms of the fourth amendment to the employment agreement, Mr. Hoch agreed to amend his annual base salary for 2012 to \$235,000 from \$350,000. Total base salary earned by Mr. Hoch for 2012 was \$199,692. .
- (9) Mr. Hoch's 2012 bonus compensation consisted of: (a) a one-time cash bonus of \$10,000 on May 24, 2012; (b) a one-time cash bonus of \$10,000 on September 17, 2012; and (c)) a one-time cash bonus of \$54,000 on November 1, 2012. All bonus compensation was granted pursuant to the terms of our employment agreement with Mr. Hoch, as amended.
- (10) On January 14, 2011, we executed a third amendment to our employment agreement with Mr. Hoch. Under the terms of the third amendment to the employment agreement, Mr. Hoch agreed to reduce his annual base salary for 2011 to \$24,000 from \$350,000.
- (11) On November 13, 2011, Mr. Hoch was granted a one-time cash bonus of \$216,000 by us pursuant to the terms of our employment agreement with Mr. Hoch, as amended.
- (12) This stock award valued at \$13,632 for Mr. Morrison was inadvertently left off our disclosure of Mr. Morrison's compensation for the fiscal year ended December 31, 2011 as disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2011, filed April 3, 2012. The figure represents the amount recognized by the executive during this period for financial statement reporting purposes only and is not compensation earned by the executive. The fair value of each restricted stock award is amortized to expense on a straight-line basis over the vesting period of the restricted stock award. The aggregate grant date fair value of the stock award was calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718. See Note 11 of the Notes to our Financial Statements contained elsewhere in this annual report on Form 10-K for a discussion of all assumptions made by us in determining values of our stock awards.
- (13)

The figure represents the amount recognized by the executive during this period for financial statement reporting purposes only and is not compensation earned by the executive. The fair value of each restricted stock award is amortized to expense on a straight-line basis over the vesting period of the restricted stock award. The aggregate grant date fair value of the stock award was calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718. See Note 11 of the Notes to our Financial Statements contained elsewhere in this annual report on Form 10-K for a discussion of all assumptions made by us in determining values of our stock awards.

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Narrative to Summary Compensation Table

Named Executive Officer Employment Agreements

We entered into an employment agreement with Michael R. Long effective February 27, 2007. Under the agreement, Mr. Long agreed to serve as our Chairman of the Board, Chief Executive Officer and Chief Financial Officer. The agreement provides for base annual salaries of \$190,000 for 2007, \$300,000 for 2008 and \$375,000 for each year thereafter, unless increased by us. In addition, Mr. Long will receive an annual bonus of \$216,000 during the term of the agreement to be paid in cash or stock at our sole discretion. Upon execution of the agreement, Mr. Long received a cash payment of \$15,000, 500,000 shares of common stock from our Employee Plan, and an aggregate of 2,500,000 shares of restricted common stock that vest annually in increments of 500,000 shares beginning on February 28, 2009. On November 12, 2009, we executed an amendment to our employment agreement with Mr. Long. Under the terms of the amended employment agreement, Mr. Long agreed to reduce his annual base salary for 2009 to \$190,000 from \$375,000. On April 12, 2010, we executed a second amendment to our employment agreement with Mr. Long. Under the terms of the amended employment agreement, Mr. Long agreed to reduce his annual base salary for 2010 to \$24,000 from \$375,000, and to change the annual bonus limit from 100% of current salary to 100% of the highest salary received in any year of the agreement. On January 14, 2011, we executed a third amendment to our employment agreement with Mr. Long. Under the terms of the amended employment agreement, Mr. Long agreed to reduce his annual base salary for 2011 to \$24,000 from \$375,000. In 2012, Mr. Long elected to receive a base salary of \$190,000 per annum in lieu of the base salary of \$375,000 that would have been due for 2012 under the employment agreement effective February 27, 2007. On July 2, 2012, we executed a fourth amendment to our employment agreement with Mr. Long. Under the terms of the amended employment agreement, Mr. Long agreed to reduce his annual base salary for 2012 to \$255,000 from \$375,000. Total base salary earned by Mr. Long for 2012 was \$217,699.

We entered into an employment agreement with Louis A. Hoch effective February 27, 2007. Under the agreement, Mr. Hoch agreed to serve as our Vice Chairman of the Board, President and Chief Operating Officer. The agreement provides for base annual salaries of \$175,000 for 2007, \$275,000 for 2008 and \$350,000 for each year thereafter, unless increased by us. In addition, Mr. Hoch will receive an annual bonus of \$216,000 during the term of the agreement to be paid in cash or stock at our sole discretion. Upon execution of the agreement, Mr. Hoch received a cash payment of \$15,000, 500,000 shares of common stock from our Employee Plan, and 2,500,000 shares of restricted common stock that vest annually in increments of 500,000 shares beginning on February 28, 2009. On November 12, 2009, we executed an amendment to our employment agreement with Mr. Hoch. Under the terms of the amended employment agreement, Mr. Hoch agreed to reduce his annual base salary for 2009 to \$175,000 from \$350,000. On April 12, 2010, we executed a second amendment to our employment agreement with Mr. Hoch. Under the terms of the amended employment agreement, Mr. Hoch agreed to reduce his annual base salary for 2010 to \$24,000 from \$350,000, and to change the annual bonus limit from 100% of current salary to 100% of the highest salary received in any year of the agreement. On January 14, 2011, we executed a third amendment to our employment agreement with Mr. Hoch. Under the terms of the amended employment agreement, Mr. Hoch agreed to reduce his annual base salary for 2011 to \$24,000 from \$350,000. In 2012, Mr. Hoch elected to receive a base salary of \$175,000 per annum in lieu of the base salary of \$350,000 that would have been due for 2012 under the employment agreement effective February 27, 2007. On July 2, 2012, we executed a fourth amendment to our employment agreement with Mr. Hoch. Under the terms of the amended employment agreement, Mr. Hoch agreed to reduce his annual base salary for 2012 to \$235,000, from \$350,000. Total base salary earned by Mr. Hoch for 2012 was \$199,692.

We do not have an employment agreement with Mr. Larry Morrison.

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OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

The following table shows grants of unexercised stock options and unvested stock by grant date outstanding on December 31, 2012, the last day of our fiscal year, to each of the named executive officers included in the Summary Compensation Table.

Outstanding Equity Awards at Fiscal Year-End Table for the Fiscal Year Ended December 31, 2012

Name (a)	Option awards (1)				Stock awards	
	Number of securities underlying unexercised options (#) exercisable (b)	Number of securities underlying unexercised options (#) unexercisable (c)	Option exercise price (\$) (e)	Option expiration date (f)	Number of shares or units of stock that have not vested (#)(2) (g)	Market value of shares or units of stock that have not vested (\$)(3) (h)
Michael R. Long						
	12/30/2003	400,000	-	0.14	12/30/2013	-
	12/29/2005	381,833	-	0.082	12/29/2015	1,355,972
	12/27/2006	-	-	-	-	2,500,611
	2/27/2007	-	-	-	-	2,500,000
	1/09/2008	-	-	-	-	7,750,000
	10/04/2012	-	-	-	-	1,000,000
Louis A. Hoch						
	12/30/2003	425,000	-	0.14	12/30/2013	-
	12/29/2005	586,147	-	0.082	12/29/2015	2,081,536
	12/27/2006	-	-	-	-	4,083,333
	2/27/2007	-	-	-	-	2,500,000
	1/09/2008	-	-	-	-	7,750,000
	10/04/2012	-	-	-	-	1,000,000
Larry Morrison						
	12/29/2005	-	-	-	-	95,156
	12/27/2006	-	-	-	-	1,000,000
	1/09/2008	-	-	-	-	700,000
	10/04/2012	-	-	-	-	450,000

(1) We did not issue any equity incentive plan awards during the years ended December 31, 2012 and 2011.

(2) Unvested common stock granted on December 29, 2005 vests on December 29, 2015, unvested common stock granted on December 27, 2006 vests on December 27, 2016 and unvested common stock granted on January 9, 2008 vests on January 9, 2018. Unvested common stock granted on February 27, 2007 vests annually over five years in increments of 500,000 shares beginning on February 28, 2009. Mr. Long and Mr. Hoch each chose to defer vesting of the increment of 500,000 shares that was granted to each of them on February 27, 2007 and was scheduled to vest on February 28, 2009, 2010, 2011 and 2012. Unvested common stock granted on October 4, 2012 vests on October 4, 2022.

(3) Calculated using the OTC Bulletin Board, or OTCBB, closing price of \$0.13 per share of our common stock on December 31, 2012.

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Narrative to Outstanding Equity Awards at Fiscal Year-End Table

Retirement Benefits

We do not have any qualified or non-qualified defined benefit plans. We do have a tax-qualified defined contribution plan pursuant to Section 401(k) of the Internal Revenue Code. All of our eligible full and part-time employees who meet certain age requirements may participate in this 401(k) plan. Participants may contribute between 1% and 15% of their pre-tax compensation. The 401(k) plan allows for us to make discretionary and matching contributions. We made no such contributions during 2012 or 2011.

Non-qualified Deferred Compensation

We do not have any non-qualified defined contribution plans or other deferred compensation plans.

Potential Payments Upon Termination or Change of Control

The employment agreements we entered into with Mr. Long and Mr. Hoch, respectively, provide for potential payments upon termination of a change of control. The agreements contain similar terms and provide that upon termination of the executive's employment with us due to death or disability, involuntary termination without cause, termination for good reason or default by us, termination due to non-renewal of the agreement, or a change of control, the executive is entitled to deferred compensation. The amount of deferred compensation shall consist of the amount which is calculated as the greater of the base salary payments that the executive would have received had his employment continued for the remaining term of the agreement (including yearly increases, if any, calculated at the maximum increase for the prior two years), or an amount equal to 2.95 times the higher annual compensation earned by him in the past two years. In addition to this compensation, the executive shall be entitled to all of the benefits otherwise provided in the agreement during that period of time which is the greater of the remaining term of the agreement, or one year, and an amount equal to the pro rata portion of his bonus compensation for the year in which his employment is terminated. In addition, all stock options and restricted stock granted to the executive shall become fully vested upon his termination for any of the aforementioned reasons. Also, in consideration of the executive's obligations for a period of two years after the termination of his employment under a non-competition clause set forth in the employment agreement, he shall be paid an amount equal to 2 times the base salary paid to him in the year prior to the expiration of the agreement.

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DIRECTOR COMPENSATION

The following table sets forth information concerning the compensation provided to each person who served as a non-employee member of our Board of Directors during the fiscal year ended December 31, 2012. Directors who are also employees are included in the Summary Compensation Table above.

Director Compensation Table for the Fiscal Year Ended December 31, 2012

Name	Fees earned or paid in cash (\$)	Stock awards (\$)	Option awards (\$)	Non-equity incentive plan compensation (\$)	Non-qualified deferred compensation earnings (\$)	All other compensation (\$)	Total (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Peter G. Kirby							
(1)	0	6,348	0	0	0	0	6,348

(1) Dr. Kirby is our sole non-employee director. He did not receive cash compensation for serving on our Board for the fiscal year ended December 31, 2012. We have previously granted stock awards to Dr. Kirby as compensation for his prior service on our Board. We have calculated that Dr. Kirby earned \$6,348 for the fiscal year ended December 31, 2012, which represents the fair value of his accrued stock awards recognized for financial statement reporting purposes only and is not compensation earned by the director. The fair value of each restricted stock award is amortized to expense on a straight-line basis over the vesting period of the restricted stock award. for the fiscal year ended December 31, 2012. At December 31, 2009, Dr. Kirby had outstanding 500,000 shares of common stock with a grant date fair value of \$27,500 granted on January 9, 2008 that vest on January 9, 2018 and 400,000 shares of common stock with a grant date fair value of \$36,000 granted on December 27, 2006 that vest on December 27, 2016. The aggregate grant date fair value of the stock award was calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718. See Note 11 of the Notes to our Financial Statements contained elsewhere in this Form 10-K for a discussion of all assumptions made by us in determining the values of our stock awards.

At December 31, 2012, Dr. Kirby had outstanding options to purchase 618,000 shares of our common stock.

Narrative to Director Compensation Table

We do not have an agreement with our independent director, Dr. Peter G. Kirby, to compensate him for his service on our Board of Directors. Mr. Long and Mr. Hoch receive no compensation for serving on our Board of Directors due to their status as officers of our Company.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following tables set forth, to our knowledge, certain information concerning the beneficial ownership of our common stock as of December 31, 2012 by each stockholder known by us to be (i) the beneficial owner of more than 5% of the outstanding shares of our common stock, (ii) each current director, (iii) each of the named executive officers included in the Summary Compensation Table, and (iv) all of our directors and current executive officers as a group.

We have determined beneficial ownership in accordance with the rules of the SEC. Except as indicated by the footnotes below, we believe, based on the information furnished to us, that the persons and entities named in the table below have sole voting and investment power with respect to all shares of common stock that they beneficially own, subject to applicable community property laws.

In computing the number of shares of common stock beneficially owned by a person and the percentage ownership of that person, we deemed outstanding shares of common stock subject to options held by that person that are currently exercisable or exercisable within 60 days after December 31, 2012. We did not deem these shares outstanding, however, for the purpose of computing the percentage ownership of any other person.

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Stockholder Known by Us to Own 5% or More of Our Common Stock

Name and address of beneficial owner	Amount and Nature of Beneficial Ownership	Percent of Shares Beneficially Owned (1)
Robert Evans (2) P.O. Box 56, Williamsville, IL 62693	14,020,000 (2)	9.6%

(1) We had a total of 147,721,077 shares of common stock issued and 142,725,833 shares of common stock outstanding on December 31, 2012.

(2) We relied on the Form 4 filed by Robert Evans with the SEC on June 9, 2011 for this information.

Name and address of beneficial owner (1)	Nature of beneficial ownership	Amount of Beneficial Ownership			Percent of Shares Beneficially Owned (2)
		Shares Owned	Shares – Rights to Acquire (3)	Total	
Michael Long (4)	Chief Executive Officer, Chief Financial Officer, and Chairman of the Board	34,728,628	781,833	35,510,461	24.3%
Louis Hoch (5)	President, Chief Operating Officer, and Vice Chairman of the Board	36,503,975	1,011,147	37,515,122	25.6%
Larry Morrison (6)	Vice President, Sales and Marketing	2,410,695	226,795	2,637,490	1.8%
Peter Kirby (7)	Director	1,200,500	618,000	1,818,500	1.2%
All directors and executive officers as a group (4 persons)		74,843,798	2,637,775	77,481,573	52.9%

(1) Unless otherwise stated, the address of each beneficial owners listed on the table is c/o Payment Data Systems, Inc., 12500 San Pedro, Suite 120, San Antonio, Texas 78216.

(2) We had a total of 147,721,077 shares of common stock issued and 142,725,833 shares of common outstanding on December 31, 2012.

(3) Represents shares subject to outstanding stock options and warrants currently exercisable or exercisable, or currently vested or that will vest, within 60 days of December 31, 2012.

(4) Includes 781,833 shares that Mr. Long has the right to acquire upon the exercise of stock options.

(5) Includes 1,011,147 shares that Mr. Hoch has the right to acquire upon the exercise of stock options.

(6) Includes 226,795 shares that Mr. Morrison has the right to acquire upon the exercise of stock options.

(7) Includes 618,000 shares that Dr. Kirby has the right to acquire upon the exercise of stock options.

As of December 31, 2012, there are no arrangements among our beneficial owners known to management which may result in a change in control of our Company.

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

TRANSACTIONS WITH RELATED PERSONS

Michael R. Long and Louis A. Hoch

As previously disclosed, in 2002, we recognized a loss on margin loans we guaranteed for Michael R. Long, then Chairman of the Board of Directors and Chief Executive Officer, and our current Chief Executive Officer and Chief Financial Officer; and Louis A. Hoch, our President and Chief Operating Officer, in the amounts of \$535,302 and \$449,371, respectively. In February 2007, we signed employment agreements with Mr. Long and Mr. Hoch that required each to repay his respective obligation to us in four equal annual payments of cash or stock or any combination thereof. In December 2007, we accepted common stock and stock options valued at \$133,826 and \$112,343 from Mr. Long and Mr. Hoch, respectively, in satisfaction of their annual payments for 2007 as provided for under their respective employment agreements.

In December 2008, Mr. Long and Mr. Hoch did not pay to us the second annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because we had deferred payment of their salary increases for 2008 called for under their respective employment agreements. At December 31, 2008, we owed Mr. Long and Mr. Hoch deferred salaries of \$110,000 and \$100,000, respectively, and Mr. Long and Mr. Hoch owed to us \$133,825 and \$112,343, respectively, for the second installment of their loan repayments. The total amount owed to us for the second installment was \$246,168 and is classified as "Related Party Receivable" on our balance sheet at December 31, 2008. On March 30, 2009, we accepted 680,715 shares of our common stock valued at \$23,825 and 352,658 shares of our common stock valued at \$12,343 from Mr. Long and Mr. Hoch, respectively, in partial satisfaction of their annual payments due to us for 2008 as provided for under their employment agreements. The partial payments of \$23,825 and \$12,343 made to us by Mr. Long and Mr. Hoch, respectively, equaled the difference between the amount each owed to us for the second installment of their loan repayments and the amount the Company owed to each executive as deferred salary. The common stock accepted from Mr. Long and Mr. Hoch was valued at \$0.035 per share, which was the closing price of the common stock on March 30, 2009. The common stock accepted from Mr. Long and Mr. Hoch was recorded as treasury stock with a total cost of \$36,168.

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

In December 2009, Mr. Long and Mr. Hoch did not pay to us the third annual installment pursuant to their respective employment agreements. They each withheld payment of the installment due because we had partially deferred payment of their salary for 2009 called for under their respective employment agreements. At December 31, 2009, we owed Mr. Long and Mr. Hoch deferred salaries for 2009 of \$162,385 and \$141,808, respectively, and Mr. Long and Mr. Hoch owed to us \$133,825 and \$112,343, respectively, for the third installment of their loan repayments. The total amount owed to us for the unpaid installments was \$456,168 and was classified as "Related Party Receivable" on our balance sheet at December 31, 2009.

On April 12, 2010, we executed a second amendment to its employment agreements with Mr. Long and Mr. Hoch. Under the terms of the second amendment to their respective amended employment agreements, Mr. Long and Mr. Hoch agreed to reduce their annual base salaries for 2010 to \$24,000 each from \$375,000 and \$350,000, respectively, and to change their annual bonus limit from 100% of current salary to 100% of the highest salary received in any year of the agreement.

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

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

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

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

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As of December 31, 2012, Mr. Long owed to us \$377,651 and Mr. Hoch owed to us \$324,686. The total amount for the unpaid installments of \$702,337 is classified as “Related Party Receivable” on our balance sheet at December 31, 2012.

On March 11, 2013, in accordance with our employment agreements with Mr. Long and Mr. Hoch, we accepted shares of our common stock owned by Mr. Long and Mr. Hoch as satisfaction in full for the remaining amounts owed to us as annual payments due to the loss on margin loans guaranteed by us for Mr. Long and Mr. Hoch.

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

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

By virtue of Mr. Long and Mr. Hoch’s officer positions with us, they are each considered a related party of our Company under federal securities law. Our Board of Directors has acknowledged that our entry into this agreement with Mr. Long and Mr. Hoch is a related party transaction and has approved such transactions.

We believe these transactions will, in the short and long term, benefit our shareholders. Removing these loans improves our balance sheet which we believe could improve our access to capital in the future in the event we decide to seek capital. We also view the repayments of these loans as positioning our Company for the next step in our plans to continue our growth and increase value for shareholders including positioning our Company for a planned application to list our shares on NYSE MKT or other national market. Finally, retiring a total of 5,575,510 shares of common stock will decrease the shares in our public float and increase the percentage ownership of our existing shareholders.

Herb Authier

During the years ended December 31, 2012 and 2011, we paid Herb Authier a total of \$31,250 and \$30,000 in cash, respectively, for services related to network engineering and administration that he provided to us. Mr. Authier is the father-in-law of Louis Hoch, our President and Chief Operating Officer.

DIRECTOR INDEPENDENCE

During the fiscal year ended December 31, 2012, Messrs. Michael R. Long, Louis A. Hoch, and Peter G. Kirby served on our Board of Directors. The Board has determined Dr. Kirby was our sole independent board member as determined as defined by Rule 5605(a)(2) of the NASDAQ Listing Rules.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

Fees Paid to the Independent Accountants

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The aggregate fees billed to us for professional accounting services, including the audit of our annual consolidated financial statements by our independent registered public accounting firm for the fiscal years ended December 31, 2012 and 2011 as included in our annual report on Form 10-K, are set forth in the table below.

	2012	2011
Audit fees	\$ 41,500	\$ 38,100
Tax fees	3,350	2,500
Total fees	\$ 44,850	\$ 40,600

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For purposes of the preceding table, the professional fees are classified as follows:

Audit Fees. This column includes fees for professional services billed for the audit of the consolidated financial statements included in our annual report on Form 10-K filing, the review of consolidated financial statements included in our quarterly reports on Form 10-Q filings, comfort letters, consents and assistance with and review of documents filed with the SEC. The fees include amounts billed to us during each respective calendar year.

Tax Fees. This column includes fees for professional services rendered by our independent registered public accounting firm for tax compliance, tax planning and tax advice. Tax compliance involves preparation of original and amended tax returns. Tax planning and tax advice encompass a diverse range of subjects, including assistance with tax audits and appeals, tax advice related to dispositions, and requests for rulings or technical advice from taxing authorities. The fees include amounts billed to us during each respective calendar year.

Audit Committee's Pre-Approval Policies and Procedures

We may not engage our independent registered public accounting firm to render any audit or non-audit service unless our Audit Committee approves the service in advance. 100% of the services performed by our independent registered public accounting firm described above were approved in advance by our Audit Committee.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.

(a)(1) Consolidated Financial Statements.

The following documents are filed in Part II, Item 8 of this annual report on Form 10-K:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2012 and 2011

Consolidated Statements of Income for the years ended December 31, 2012 and 2011

Consolidated Statements of Changes in Stockholders' Equity (Deficit) for the years ended December 31, 2012 and 2011

Consolidated Statements of Cash Flows for the years ended December 31, 2012 and 2011

Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules.

All financial statement schedules have been omitted as they are not required, not applicable, or the required information is otherwise included.

(a)(3) 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).

3.3 Articles of Amendment to the Amended and Restated By-laws (included as exhibit A to the Schedule 14C filed April 18, 2007, and incorporated herein by reference).

4.1 Amended and Restated 1999 Employee Comprehensive Stock Plan (included as exhibit 4.1 to the Form S-8 filed May 25, 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, File No. 333-30958, filed February 23, 2000, and incorporated herein by reference).

4.4 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 22, 2003 (included as exhibit 10.3 to the Form 10-Q filed November 14, 2003, and incorporated herein by reference).

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

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

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

10.5 Stock Purchase Agreement between the Company and Robert D. Evans, dated January 18, 2007 (included as exhibit 10.1 to the Form 8-K filed January 23, 2007, and incorporated herein by reference).

10.6 Stock Purchase Agreement between the Company and Robert D. Evans, dated March 1, 2007 (included as exhibit 10.1 to the Form 8-K filed March 5, 2007, and incorporated herein by reference).

10.7 First Amendment to Employment Agreement between the Company and Michael R. Long, dated November 12, 2009 (included as exhibit 10.15 to the Form 10-Q filed November 16, 2009, and incorporated herein by reference).

10.8 First Amendment to Employment Agreement between the Company and Louis A. Hoch, dated November 12, 2009 (included as exhibit 10.16 to the Form 10-Q filed November 16, 2009, and incorporated herein by reference).

10.9 Second Amendment to Employment Agreement between the Company and Michael R. Long, dated April 12, 2010 (included as exhibit 10.16 to the Form 10-K filed April 15, 2010, and incorporated herein by reference).

10.10 Second Amendment to Employment Agreement between the Company and Louis A. Hoch, dated April 12, 2010 (included as exhibit 10.17 to the Form 10-K filed April 15, 2010, and incorporated herein by reference).

10.11 Bank Sponsorship Agreement between the Company and University National Bank, dated August 29, 2011 (included as exhibit 10.18 to the Form 10-K filed April 3, 2012, and incorporated herein by reference).

10.12 Third Amendment to Employment Agreement between the Company and Michael R. Long, dated January 14, 2011 (included as exhibit 10.19 to the Form 10-K filed April 3, 2012, and incorporated herein by reference).

10.13 Third Amendment to Employment Agreement between the Company and Louis A. Hoch, dated January 14, 2011 (included as exhibit 10.20 to the Form 10-K filed April 3, 2012, and incorporated herein by reference).

10.14 Fourth Amendment to Employment Agreement between the Company and Michael R. Long, dated July 2, 2012 (included as exhibit 10.18 to the Form 10-Q filed August 20, 2012, and incorporated herein by reference).

10.15 Fourth Amendment to Employment Agreement between the Company and Louis A. Hoch, dated July 2, 2012 (included as exhibit 10.19 to the Form 10-Q filed August 20, 2012, and incorporated herein by reference).

10.16 Confidential Compromise Settlement Agreement and Full and Final Release by and between FiCentive, Inc. and SmartCard Marketing Systems, Inc., dated November 20, 2012 (included as exhibit 10.1 to the Form 8-K filed November 28, 2012).

10.17

First Amendment to Lease Agreement dated August 22, 2003 between the Company and Frost National Bank, Trustee for a Designated Trust, dated February 6, 2006 (filed herewith).

10.18 Second Amendment to Lease Agreement dated August 22, 2003 between the Company and Frost National Bank, Trustee for a Designated Trust, dated October 7, 2009 (filed herewith).

10.19 Third Amendment to Lease Agreement dated August 22, 2003 between the Company and Frost National Bank, Trustee for a Designated Trust, dated October 12, 2013 (filed herewith).

14.1 Code of Ethics (included as exhibit 14.1 to the Form 10-K filed March 30, 2004, and incorporated herein by reference).

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16.1 Letter from Ernst and Young LLP to the Securities and Exchange Commission dated February 10, 2004 (included as exhibit 16 to the Form 8-K filed February 11, 2004, and incorporated herein by reference).

21.1 Subsidiaries of the Company (included as exhibit 21.1 to the Form 10-K filed March 31, 2008, and incorporated herein by reference).

23.1 Consent of Akin Doherty Klein & Feuge, P.C. (filed herewith).

31.1 Certification of the Chief Executive Officer/Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).

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

101.INS* XBRL Instance Document (filed herewith).

101.SCH* XBRL Taxonomy Extension Schema Document (filed herewith).

101.CAL* XBRL Taxonomy Extension Calculation Linkbase Document (filed herewith).

101.DEF* XBRL Taxonomy Extension Definition Linkbase Document (filed herewith).

101.LAB* XBRL Taxonomy Extension Label Linkbase Document (filed herewith).

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

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

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Payment Data Systems, Inc.

Date: April 1, 2013

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)

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: April 1, 2013

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)

Date: April 1, 2013

By: /s/ Louis A. Hoch
Louis A. Hoch
President, Chief Operating Officer, and
Director

Date: April 1, 2013

By: /s/ Peter G. Kirby
Peter G. Kirby
Director