



*The management's discussion and analysis ("MD&A") which follows, is provided to assist readers in their assessment and understanding of the consolidated results of operations, the financial position and changes in cash flows of LMS Medical Systems Inc. ("LMS" or "the Company") for the first quarter of 2007 ended June 30, 2006. This MD&A should be read in conjunction with the unaudited interim first quarter financial statements as at June 30, 2006 and for the three-month period ended June 30, 2006 and 2005 and the annual audited consolidated financial statements and financial statement notes of LMS as at March 31, 2006 and 2005 and for the years ended March 31, 2006 and 2005, the five-month period ended March 31, 2004 and the year ended October 31, 2003, which are prepared in accordance with Canadian generally accepted accounting principles. Material differences between Canadian and United States generally accepted accounting principles, as applicable to LMS, are set forth in Note 17 to the annual audited consolidated financial statements of LMS.*

### **Note Regarding Forward-Looking Statements**

*Our MD&A contains forward-looking statements which reflect our Company's current expectations regarding future events. The forward-looking statements in this quarterly filing, which includes this MD&A describe our expectations on August 9th, 2006. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect" and "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause actual results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to LMS. Investors should consult the "Risk Factors" section of the Company's form 20-F as well as our ongoing quarterly filings and annual reports for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. We assume no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.*

*As at August 9th, 2006, there were 18,001,495 common shares outstanding, 1,910,397 stock options, 121,868 deferred share units and 608,824 warrants outstanding to purchase common shares.*

*All dollar figures in this MD&A are in Canadian dollars unless otherwise indicated. "We", "us", "our", "our Company" or "LMS" means LMS Medical Systems Inc. and its subsidiaries unless otherwise indicated.*

### **Overview**

For the past ten years, LMS has actively been developing and commercializing a series of leading edge software-based products to be used as risk management tools for obstetrics. LMS's pipeline of proprietary software tools addresses critical unmet medical needs in labor and delivery settings. Based on advanced medical research focusing on the Labor & Delivery cycle, our unique technology provides obstetrical teams and hospitals with state-of-the-art clinical decision support tools to assist them in achieving clinical and cost effective interventions.

While continuing to pursue its core research and development of new software tools, LMS has also been strengthening its product development as well as the implementation and enlargement of its sales and distribution network. Our core technology, CALM™, was developed at the McGill University Faculty of Medicine, in Montréal, Canada, with Dr. Emily Hamilton, our VP Medical Research, as the principal investigator.

### **FIRST QUARTER HIGHLIGHTS:**

- Revenues more than double over Q1 the prior year;
- Back log of signed contracts has grown to \$2.0 million;
- Identified sales opportunities up sharply to \$25 million;
- LMS new product, CALM Shoulder Screen, continues to attract gratifying attention in the marketplace.


**Selected Financial Information**  
**Three-month period ended June 30, 2006 and 2005**

|   | 3 Months                            |                                  |
|---|-------------------------------------|----------------------------------|
|   | June 30,<br>2006<br>\$              | June 30,<br>2005<br>\$           |
| <b>Revenue</b>  |                                     |                                  |
| Software licenses   | 298,229                             | 179,869                          |
| Technical support and other                                       | 332,922                             | 88,046                           |
|   | <b>631,151</b>                      | <b>267,915</b>                   |
| <b>Operating Expenses</b>   |                                     |                                  |
| Research and development  | 1,100,603                           | 975,747                          |
| Investment Tax Credits  | (45,000)                            | (56,350)                         |
| Net research and development                                      | 1,055,603                           | 919,397                          |
| Royalties and other direct costs                                  | 81,271                              | 33,938                           |
| Selling and market development                                    | 790,524                             | 583,067                          |
| Administrative  | 756,691                             | 669,739                          |
| Customer support  | 247,911                             | 253,830                          |
| Quality assurance   | 49,091                              | 55,188                           |
| Stock Option Expense  | 164,085                             | 225,000                          |
| Amortization expense  | 85,483                              | 49,409                           |
| Foreign exchange loss (gain)                                      | (5,411)                             | 6,852                            |
|   | <b>3,225,248</b>                    | <b>2,796,420</b>                 |
| <b>Operating loss</b>   | <b>(2,594,097)</b>                  | <b>(2,528,505)</b>               |
| Interest and other income, net                                    | (43,691)                            | (66,479)                         |
| <b>Net loss</b>   | <b>(2,550,406)</b>                  | <b>(2,462,026)</b>               |
| <b>Basic and diluted loss per share</b>                           | <b>(0.15)</b>                       | <b>(0.15)</b>                    |
| <b>Cash flows related to:</b>                                     |                                     |                                  |
| Operating activities  | (2,248,488)                         | (1,222,406)                      |
| Investing activities  | (579,556)                           | 8,844,686                        |
| Financing activities  | 2,319,089                           | (10,694)                         |
|   | <b>December 31,<br/>2005<br/>\$</b> | <b>March 31,<br/>2006<br/>\$</b> |
| <b>Balance sheet data</b>   |                                     |                                  |
| Cash, cash equivalents, short-term investments<br>and investments | 5,577,421                           | 5,581,202                        |
| Total assets  | 7,591,155                           | 7,301,200                        |
| Total long-term debt (including current portion)                  | 75,180                              | 85,816                           |
| Total shareholders' equity  | 4,923,182                           | 4,794,762                        |

**Selected Quarterly Financial Information**

|                                      | <b>2007<br/>Q1</b> |
|--------------------------------------|--------------------|
| Revenue                              | 631,151            |
| Operating Loss                       | 2,594,097          |
| Net Loss                             | 2,550,406          |
| Basic and Diluted Net Loss per Share | (0.15)             |

|   | <b>2006</b> |           |           |           |              |
|---|-------------|-----------|-----------|-----------|--------------|
|   | <b>Q1</b>   | <b>Q2</b> | <b>Q3</b> | <b>Q4</b> | <b>Total</b> |
| Revenue                                 | 267,915     | 550,704   | 501,820   | 262,065   | 1,582,504    |
| Operating Loss                          | 2,528,505   | 2,183,677 | 2,079,579 | 2,844,654 | 9,636,415    |
| Net Loss                                | 2,462,026   | 2,133,244 | 2,016,561 | 2,794,341 | 9,406,172    |
| Basic and Diluted<br>Net Loss per Share | (0.15)      | (0.13)    | (0.12)    | (0.17)    | (0.57)       |

|   | <b>2005</b> |           |           |           |              |
|---|-------------|-----------|-----------|-----------|--------------|
|   | <b>Q1</b>   | <b>Q2</b> | <b>Q3</b> | <b>Q4</b> | <b>Total</b> |
| Revenue                                 | 231,457     | 76,339    | 677,816   | 74,685    | 1,060,297    |
| Operating Loss                          | 1,849,493   | 2,334,647 | 2,334,274 | 2,945,464 | 9,463,878    |
| Net Loss                                | 1,801,260   | 2,275,272 | 2,274,681 | 2,885,320 | 9,236,533    |
| Basic and Diluted<br>Net Loss per Share | (0.13)      | (0.16)    | (0.15)    | (0.18)    | (0.60)       |

**Results of operations**

*For the three-month period ended June 30, 2006 compared to the three-month period ended June 30, 2005 ("2005")*

**Revenue**

Our revenue for the three-month period ended June 30, 2006 increased to \$631,000 compared to \$268,000 in 2005. Sales of software licenses generated \$298,000 in 2006 compared to \$180,000 in 2005. Technical support and other revenue increased to \$333,000 from \$88,000 in 2005. The total number of software installations was higher in 2006 than in 2005. The increased number of installations and the continued increase in the installed base of clients substantially increased technical support revenues. Hardware revenue was nil for both periods. We do not expect to generate significant hardware revenues on a going forward basis. As the majority of our revenues is generated in the United States, the revenues continue to be negatively impacted by the weakness of the US dollar compared to the Canadian dollar, our reporting currency.

**Research and Development expenses and Investment Tax Credits**

For the three-month period ended June 30, 2006 R&D expenditures before investment tax credits were \$1,101,000 compared to \$976,000 in 2005. The increase was primarily due to increased salaries and consulting fees related to ongoing product development initiatives, including work on the interface of CALM with distributor systems. In addition, the development team continues to work on other product features and upgrades to the current CALM version and risk management products.

Investment tax credits were \$45,000 for the three-month period ended June 30, 2006 compared to \$56,000 in 2005.



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**Royalties and other direct costs of revenue**

Royalties and other direct costs of revenue for the three-month period ended June 30, 2006 increased to \$81,000 from \$34,000 in 2005. Royalties and other direct costs are primarily a function of revenues. These costs consist of royalty payments for third party software used in installing our software products and direct costs associated with the installation of our systems.

**Selling and Market Development**

Selling and market development expenses for the three-month period ended June 30, 2006 were \$791,000 compared to \$583,000 in 2005. The increase was due to new employees in product and clinical management and expenses supporting these activities. Product management and clinical specialists focus on current and future product and service integration. Sales travel and other expenses increased somewhat, as they related to increased sales activities. Marketing expenses and activities were in line with 2005.

**Administrative**

Administrative expenses for the three-month period ended June 30, 2006 increased to \$757,000 compared to \$670,000 for the same period in 2005. The increase was primarily due to increased professional fees and some increases in office and general expenses.

**Customer Support**

For the three-month period ended June 30, 2006 customer support expenses were \$248,000 and in line with \$254,000 in 2005.

**Quality Assurance**

For the three-month period ended June 30, 2006 quality assurance expenses were \$49,000 and in line with \$55,000 in 2005.

**Stock Option Expense**

We recorded \$164,000 in stock option expense during the three-month period ended June 30, 2006 compared to \$225,000 in 2005. The decrease in stock option expense is primarily due to a lower number of options being granted in 2006, compared to 2005 and 2004. The stock option expense is amortized over three years, resulting in approximately 60%, 30% and 10% of the stock option expense being recorded in the first, second and third year, respectively, from the date of grant.

**Amortization of property, plant and equipment and patents**

Amortization of property, plant and equipment and patents for the three-month period ended June 30, 2006 was \$85,000 compared to \$49,000 in 2005. The increase was due to additional capital expenditures and patents during the last year. We do not expect to make large capital expenditures in the coming quarters.

**Foreign Exchange**

For the three-month period ended June 30, 2006, we had a foreign exchange gain of \$5,000 compared to a loss of \$7,000 in 2005.

**Operating Loss and Net Loss**

After considering above revenues and expenses, our operating loss for the three-month period ended June 30, 2006 was \$2,594,000 compared to \$2,529,000 in 2005.

We generated net interest income of \$44,000 for the three-month period ended June 30, 2006, compared to \$66,000 in 2005. The interest income was generated on cash and cash equivalents from the proceeds of the equity issues in prior periods and was lower due to lower average liquidities.

As a result, the net loss for the three-month period ended June 30, 2006 totaled \$2,550,000 (\$0.15 per share) compared with \$2,462,000 (\$0.15 per share) in 2005.



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## Liquidity and Capital Resources

### Operating activities

Cash flow used for operations totaled \$2,248,000 for the three-month period ended June 30, 2006 compared to \$1,222,000 in 2005. Cash flows used in operations before net changes in non-cash working capital items were \$2,115,000 for the three-month period ended June 30, 2006 compared to \$2,030,000 in 2005.

In 2006, cash used in our operating activities is mainly explained by our net loss of \$2,550,000 offset by the following non-cash expenses: amortization of \$85,000, stock option expense of \$165,000, compensation expense under the DSU and bonus plans of \$35,000 and \$150,000, respectively with the balance explained by the outflow from non-cash operating working capital items of \$133,000. In 2005, cash used in our operating activities was a function of our net loss of \$2,462,000 offset by amortization of \$49,000, stock option expense of \$225,000 compensation expense under the DSU and bonus plans of \$57,000 and \$100,000, with the balance explained by inflow from the changes in non-cash operating working capital of \$809,000.

### Investing activities

Our investing activities for the three-month period ended June 30, 2006, consisted of \$75,000 for the acquisition of capital assets and patents compared to \$119,000 in 2005. For the three-month period ended June 30, 2006 we had an outflow of \$505,000 representing the purchase of short-term investments compared to the maturity of short-term investments of \$8,964,000 in 2005.

### Financing activities

During the three-month period ended June 30, 2006, financing activities used \$11,000 of cash, representing the repayment of obligations under capital leases, compared to \$11,000 in 2005. In 2006, we also completed a private placement of \$2,500,000 at \$2.00 per share. Share issue expenses of \$170,000 were also recorded within the deficit.

As a result of the above activities our cash and cash equivalents decreased by \$509,000 for the three-month period ended June 30, 2006 compared to an increase of \$7,612,000 in 2005.

As of June 30, 2006 we have no debt other than capital leases, which totaled \$75,000 and are repayable over the next 5 years. Our operating obligations totaled \$416,000 with \$230,000 due within one year and the balance within two to five years.

### Future Outlook

In fiscal 2007, we are focusing on substantially increasing sales and expanding our customer base. It is also our goal to deliver enhancements to our product line.

Our revenue is expected to increase significantly in 2007 compared to 2006, predominantly due to the fact that we have released CALM 3.0, a building block for growth, and currently have a number of orders pending for this product. We expect to install CALM 3.0 in a number of hospitals in the United States in the coming months and expect that we will have additional sales of this product throughout the year. As a result of increased system sales and our growing client base, revenues from maintenance and technical support service agreements are also expected to increase commensurate with the increase in our install base. We also expect that the release of CALM Shoulder Screen, earlier this year, will add to our customer base and product revenue in 2007.

Based on our current operating plan, we expect our research and development expenses to remain stable as we focus on a timely interface of our systems with a distributor and continuing the development of our CALM suite of products.

Royalties and other direct costs are expected to increase commensurate with the increase in sales, and also as a function of sales mix.



Selling and market development expenses are expected to increase, due to greater commission expenses related to additional software sales and the addition of product management clinical specialists focusing on product and service integration and development. We will focus our sales efforts on CALM 3.0 and CALM Shoulder Screen as well as continue to broaden our sales reach and customer focus.

Administrative expenses are expected to remain in line with the levels of expense experienced in 2006. Customer support expenses will increase due to a growing installed hospital base, but we expect these increases to be more than offset by increased software and maintenance revenues. Based on the current operating plan, the anticipated revenue increases should more than compensate for the expected slight increase in the total expenses. In anticipation of increased revenues for the coming year, we believe we will have sufficient resources to fund operations for the next twelve months.

To date, we have financed our operations, technology development, patent filings and capital expenditures primarily through issuance of shares and issuances of convertible notes by way of private placements, with the receipt of investment tax credits earned on eligible expenditures, by loans and promissory notes from financial institutions and by capital leases. Since our inception, we have raised gross proceeds in excess of \$50.6 million from equity-based financings.

In light of the inherent uncertainties associated with the realization of our operating plan, and consistent with our past practice of keeping financial and operating flexibility, management anticipates raising additional financing. Funding requirements may vary depending on a number of factors, including the progress of our research and development program, our revenue growth, the establishment of collaborations and the market acceptance of our products in North America and internationally.

When additional funds are required, potential sources of financing include strategic relationships and public or private sales of our common shares. We do not have any committed sources of financing at this time and it is uncertain whether additional funding will be available when the need arises on terms that will be acceptable to us. If funds are raised by issuing additional common shares, or other securities convertible into our common shares, the ownership interests of our existing shareholders will be diluted. If we are unable to obtain financing when required, we will not be able to carry out our business plan, including marketing and distribution initiatives. We would have to significantly limit our operations and business, and our financial condition and results of operations would be materially harmed.

### **Critical Accounting Policies and Estimates**

Our financial statements have been prepared in accordance with Canadian generally accepted accounting principles. As further described in note 17 of the annual consolidated financial statements, these accounting principles differ in certain respects from those that would have been followed had these financial statements been prepared in conformity with United States generally accepted accounting principles and the related rules and regulations adopted by the United States Securities and Exchange Commission. The preparation of financial statements by management in accordance with generally accepted accounting principles requires the selection of accounting policies from existing acceptable alternatives. Our critical accounting policies and estimates include the following:

#### **Revenue recognition**

Revenue consists primarily of revenue from the sales of software licenses, hardware and technical support services. We recognize revenue in accordance with the provision of the American Institute of Certified Public Accountants Statement of Position [SOP] No. 97-2, Software Revenue Recognition.

We recognize revenue from hardware and software licenses when persuasive evidence of an arrangement exists, delivery, installation and client's acceptance have occurred, the sales price is fixed or determinable, and collection is probable.



Revenue from technical support services, which is generally paid in advance, is deferred and recognized rateably over the period for which the technical support service is provided. Other service revenues are recognized when services are provided.

Revenue on arrangements that includes multiple elements such as hardware, software licenses and services is allocated to each element based on vendor specific objective evidence [VSOE] of the fair value of each element. Allocated revenue for each element is recognized when revenue recognition criteria have been met for each element. VSOE is determined based on the price charged when each element is sold separately.

#### **Research and development expenses and Investment Tax Credits**

Research costs are charged against income in the year of expenditure. Development costs are charged against income in the period of expenditure unless a development project meets the criteria under Canadian generally accepted accounting principles for deferral and amortization.

Amounts received or receivable resulting from government assistance programs, including grants and investment tax credits for research and development, are reflected as reductions of the cost of assets or expenses to which they relate at the time eligible expenses are incurred, provided that there is reasonable assurance that the benefits will be realized. The risks of change to estimates for investment tax credits receivable relate to the acceptance of LMS research and development investment tax claims by government authorities. The claims, which contain several research and development projects, are made on an annual basis and may take in excess of one year to be finalized and completed. In reviewing the claim, the government authorities take into consideration two primary factors in assessing the eligibility of the investment tax credit claim: [1] the technical aspects of the projects claimed must meet the specific scientific criteria and [2] the claim must contain only the eligible expenses related to projects described in the tax filings. The risk of change to the estimate relates to the fact that certain projects or expenses involve judgment and could be disallowed because of one or both of the factors identified above. Any favorable or unfavorable adjustment that may result following assessment by government authorities is recorded to income in the subsequent period when such assessment is performed.

As at June 30, 2006, our investment tax credit receivables recorded amount to \$305,000 relating to the 2006 and current year claim. To date, substantially all of our investment tax credits claimed filed and assessed by the government authorities have been accepted favourably as submitted.

#### **Stock-based compensation plan**

As a result of amendments made in October 2003 to the provisions of the CICA Handbook Section 3870, effective November 1, 2003, we changed our method of accounting for employee stock-based compensation and decided to adopt the fair value based method of accounting for all its stock-based compensation. We adopted these changes using the prospective application transitional alternative in accordance with the transitional provisions of CICA Handbook Section 3870. Accordingly, the fair value based method is applied to awards granted, modified or settled on or after November 1, 2003. Prior to the adoption of the fair value based method, as permitted by Section 3870, we had chosen to continue our existing policy of recording no compensation cost on the grant of stock options to employees.

When stock options are exercised, capital stock is credited by the consideration paid together with the related portion previously credited to contributed surplus when compensation costs were charged against income. The prospective method omits the effects of awards granted, modified or settled before November 1, 2003. This change has no impact on the net loss for the five-month period ended March 31, 2004 since no options were granted during that period.

We provide pro forma disclosure of the compensation costs based on the fair value method for awards granted prior to November 1, 2003 under the employee stock option plan.



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Stock-based compensation expense and pro forma disclosure of the stock-based compensation expense for all options granted under our stock option plan is determined using the fair value method computed with the Black Scholes option-pricing model. The related expense is recognized over the vesting period of such options.

**Income taxes**

We follow the liability method of accounting for income taxes. Under this method future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the periods in which the assets or liabilities are expected to be realized or settled. Changes in these balances are included in net earnings of the period in which they arise.

**Related party transactions**

The Company incurred fees of \$48,075 during the year under a management services agreement with a related company having one common director.

**Off-Balance Sheet Arrangements**

LMS does not have any off-balance sheet arrangements at June 30, 2006.

**Foreign Operations and Foreign Currency Transactions**

Large portion of our revenues and some of our expenses are generated in the United States. From October 31, 2002 to March 31, 2006 the Canadian dollar has appreciated against the US dollar by approximately 30%. The continued weakness of the US dollar has a negative effect on our revenues, offset somewhat by the expenses generated in the United States.

**Risk Factors**

For a more detailed discussion of risk factors that could materially affect our results of operations and financial condition, please refer to the Company's Form 20F.

**Disclosure Controls and Procedures**

The Company's management is responsible for establishing and maintaining the Company's disclosure controls and procedures to ensure that information used internally and disclosed externally is complete and reliable. The Chief Executive Officer and the Chief Financial Officer of the Company have evaluated the effectiveness of the Company's disclosure controls and procedures and have concluded that they are adequate and effective as at the end of the fiscal year ended March 31, 2006, and for the quarter ended June 30, 2006, based on such evaluation.

**Other MD&A requirements**

All relevant information related to our Company is filed, in Canada, electronically at [www.sedar.com](http://www.sedar.com) and in the United States of America at [www.sec.gov](http://www.sec.gov).